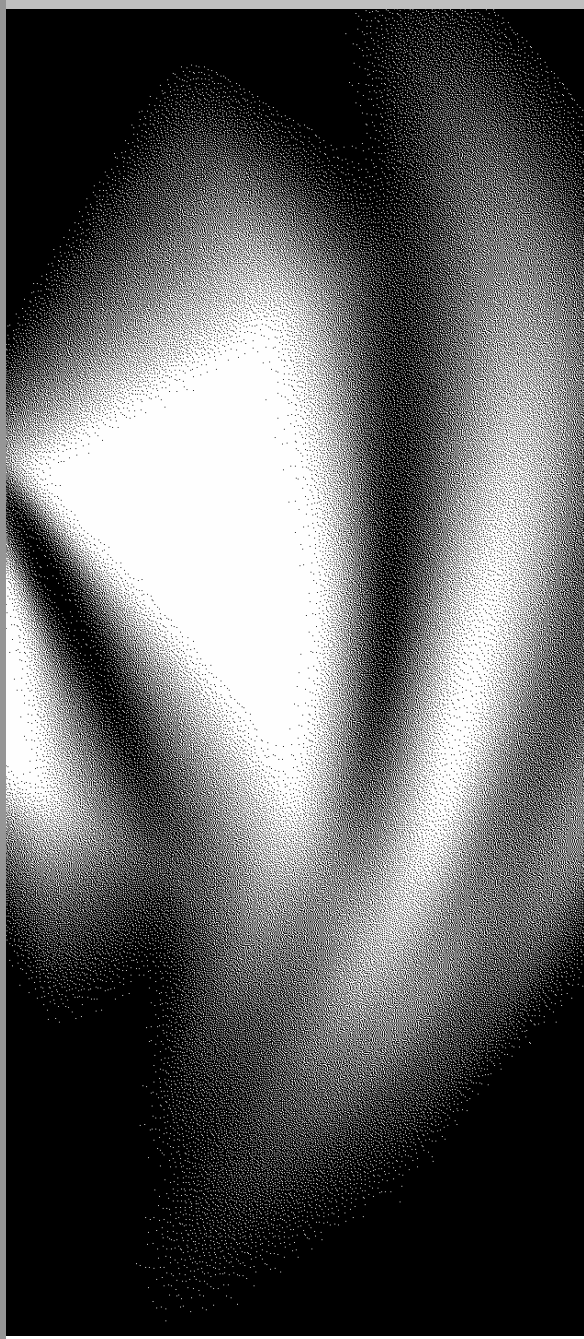
Australian Government
Productivity Commission

# Rules of Origin under the Australia–New Zealand Closer Economic Relations Trade A

Productivity Commission Research Report

28 May 2004



**ISBN** 1 74037 149 6



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**Publications Inquiries:**
Media and Publications
Productivity Commission
Locked Bag 2 Collins Street East
Melbourne VIC 8003

Tel: (03) 9653 2244
Fax: (03) 9653 2303
Email: maps@pc.gov.au

**General Inquiries:**
Tel: (03) 9653 2100 or (02) 6240 3200

**An appropriate citation for this paper is:**

Productivity Commission 2004, *Rules of Origin under the Australia–New Zealand Closer Economic Relations Trade Agreement*, Research Report, Canberra.

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# Foreword

Rules of origin establish which goods produced in Australia and New Zealand should be accorded preferential tariff treatment under the Australia–New Zealand Closer Economic Relations Trade Agreement (CER). The rules have an important bearing on trans-Tasman trading opportunities.

The Australian Government requested this research study because of the difficulty that some Australian and New Zealand firms face in meeting the current rules of origin. It takes place in parallel with an officials' review of the rules of origin under CER agreed at the August 2003 meeting of Australian and New Zealand Trade Ministers. It is also a time when both governments have been discussing the development of a single economic market comprising Australia and New Zealand.

The Commission's report has drawn on information and views from a wide range of sources in Australia and New Zealand, including companies engaged in trans-Tasman trade, industry associations, government agencies in both jurisdictions and international organisations. The study has benefited from roundtable discussions held to consider findings and recommendations of an interim report, as well as submissions from interested parties. The Commission wishes to thank the many people who have contributed to the study.

Gary Banks
Chairman
May 2004

# Terms of reference

*The Productivity Commission Act 1998*

**STUDY OF THE RULES OF ORIGIN ARRANGEMENTS UNDER THE AUSTRALIA–NEW ZEALAND CLOSER ECONOMIC RELATIONS TRADE AGREEMENT**

The Productivity Commission is requested to undertake a research study to examine the issue of Australia's rules of origin arrangements under the Australia New Zealand Closer Economic Relations Trade Agreement (CER).

In undertaking the study the Commission is to:

a) Identify any economic and administrative problems with the operation and design of the rules of origin.

b) Propose any changes, including design or model changes, to ensure the rules of origin continue to promote the goals of the CER.

c) Assess the costs and benefits, including the regulatory burden, of any proposed changes.

d) Consider relevant international developments.

In addressing these points, the Commission is requested to consult with interested parties, including industry, relevant Commonwealth Departments and Agencies and the New Zealand Government.

The Commission is required to produce an interim report within 4 months of receipt of the reference and a final report within 9 months of receipt of the reference. The final report will be published following Government consideration of its contents.

IAN CAMPBELL

[received 28 August 2003]

# Contents

**BOXES**

## FIGURES



## TABLES

# Abbreviations

| | |
|---|---|
| ABS | Australian Bureau of Statistics |
| ACS | Australian Customs Service |
| ANDEAN | Andean Subregional Integration Agreement |
| ANZSIC | Australian and New Zealand Standard Industrial Classification |
| APEC | Asia–Pacific Economic Cooperation |
| ASEAN | Association of South East Asian Nations |
| ATMI | American Textile Manufacturers Institute |
| AUSFTA | Australia–United States Free Trade Agreement |
| BAFTA | Baltic Free Trade Agreement |
| CACM | Central American Common Market |
| CARICOM | Caribbean Community |
| CER | Australia–New Zealand Closer Economic Relations Trade Agreement |
| CEFTA | Central European Free Trade Agreement |
| CEMAC | Economic and Monetary Community of Central Africa |
| CEPT | common effective preferential tariffs |
| CIS | Commonwealth of Independent States |
| COMESA | Common Market for Eastern and Southern Africa |
| CTC | change in tariff classification |
| CTH | change in tariff heading |
| CTS | consolidated tariff schedules |
| DFAT | Department of Foreign Affairs and Trade (Australia) |
| DITR | Department of Industry, Tourism and Resources (Australia) |
| DMRM | determined manufactured raw materials |
| EAC | East African Community |
| EAEC | Eurasian Economic Community |

| | |
|---|---|
| EC | European Community |
| ECO | Economic Cooperation Organization |
| EEA | European Economic Area |
| EFTA | European Free Trade Area |
| EMA | Employers & Manufacturers Association (Northern) |
| EU | European Union |
| FDI | foreign direct investment |
| fis | free into store |
| fob | free on board |
| FTA | free trade agreement |
| fwc | factory works cost |
| GATS | General Agreement on Trade in Services |
| GATT | General Agreement on Tariffs And Trade |
| GCC | Gulf Cooperation Council |
| GSP | Generalized System of Preferences |
| GSTP | Global System of Trade Preferences |
| HCDC | Harmonized Commodity Description and Coding |
| HS | Harmonized System |
| IDB | integrated data base |
| ISAC | Industry Sector Advisory Committee for Textiles and Apparel |
| ISIC | International Standard Industrial Classification |
| LAIA | Latin American Integration Association |
| MERCOSUR | Acuerdo Comercial–Mercado Común del Sur (Southern Common Market Agreement) |
| MFN | most favoured nation |
| MSG | Melanesian Spearhead Group |
| NAFTA | North American Free Trade Agreement |
| NZ | New Zealand |
| NZS | New Zealand Statistics |
| OAS | Organization of American States |

| | |
|---|---|
| OCTs | overseas countries and territories |
| OECD | Organization for Economic Co-operation and Development |
| ORR | Office of Regulation Review |
| PACIA | Plastics and Chemicals Industries Association |
| PANEURO | Pan-European |
| PATCRA | Papua New Guinea–Australia Trade and Commercial Relations Agreement |
| PC | Productivity Commission |
| PECC | Pacific Economic Cooperation Council |
| PTA | preferential trade agreement |
| RoO | rules of origin |
| RTA | regional trade agreements |
| RVC | regional value content |
| SAARC | South Asian Association for Regional Cooperation |
| SAFTA | Singapore–Australia Free Trade Agreement |
| SAPTA | SAARC Preferential Trading Arrangement |
| SPARTECA | South Pacific Regional Trade and Economic Cooperation Agreement |
| SME | small to medium enterprises |
| TCF | textiles, clothing and footwear |
| TCO | tariff concession order |
| TFIA | Council of Textile and Fashion Industries of Australia |
| TVBD | transaction value build-down |
| US | United States |
| UNCTAD | United Nations Conference on Trade and Development |
| WAEMU | West African Economic and Monetary Union |
| WCO | World Customs Organisation |
| WTA | World Trade Analyzer |
| WTF | World Trade Flows |
| WTO | World Trade Organization |

# OVERVIEW

## Key points

- Rules of origin (RoO), such as those in the CER Agreement between Australia and New Zealand, are required to confine access to trade concessions to goods from member countries.
- RoO are discriminatory. They provide an incentive for producers to purchase inputs from suppliers in member countries rather than from other, lower-cost, sources. The additional costs can outweigh the gains from more liberal trading arrangements.
- The global increase in the number of preferential trading agreements (PTAs) will result in diverse RoO, adding to the complexity and compliance costs of engaging in trade.
  - Origin rules based on the change in tariff classification model adopted in most non-CER PTAs differ significantly in detail. The benefits for traders from adopting this model for all of Australia's PTAs would consequently be minor.
- CER RoO are relatively 'clean' and simple. Nevertheless, they have some shortcomings, primarily because they have not kept pace with changes in technology and the organisation of production. The shortcomings:
  - reduce efficiency; and
  - add to compliance and administration costs.
- Trade concessions available under CER have declined in value as tariffs have been reduced and the relevance of origin rules has consequently diminished.
  - Over half of the value of trans-Tasman trade is in items with a most favoured nation tariff rate of zero and is unaffected by RoO.
  - A further 35 per cent of that trade is in items with a tariff rate of 5 per cent or less and is not significantly affected by RoO.
  - The remaining 12 per cent or so is in items with a tariff rate of more than 5 per cent and is more likely to be affected by RoO.
- In view of the maturity of the CER agreement and the significant limitations of the alternative models, the basic framework of the CER RoO should remain unchanged.
- The most fruitful approach to addressing problems with CER origin rules would be:
  - to implement, as soon as practicable, some relatively minor changes to reduce operational problems; and
  - to liberalise the current rules by applying a waiver to provide duty free entry for CER goods manufactured in Australia or New Zealand which face trans-Tasman tariff differences of 5 percentage points or less.
- These proposals are consistent with the intent of the CER Agreement, particularly the goal of eliminating barriers to CER trade. They would alleviate the present regulatory burden and would not impose significant adjustment costs.
- The proposals also are consistent with recent initiatives by both governments to develop a single economic market comprising Australia and New Zealand.

# Overview

This study examines Australia's rules of origin (RoO) arrangements under the Australia–New Zealand Closer Economic Relations Trade Agreement (CER). In particular, it identifies problems with the operation of the RoO and explores options for change.

The CER entered into force in 1983, building on earlier preferential agreements between Australia and New Zealand. Its primary objectives are to promote trans-Tasman trade and strengthen the relationship between Australia and New Zealand.

## What are rules of origin?

RoO are the criteria used to determine where a good has been made for the purpose of ensuring that only the products of countries which are a party to a preferential trade agreement (PTA), such as the CER, obtain concessional entry under the agreement.

In the absence of RoO, there would be an incentive to import goods from a third party country into the PTA region through the member with the lowest most favoured nation (MFN) tariffs in order to take advantage of duty concessions *within* the region. For example, there would be an incentive to import clothing produced outside the CER region into New Zealand (and pay the tariff of 19 per cent) for transhipment to Australia at zero additional tariff (rather than import directly into Australia and pay the normal tariff of 25 per cent).

There is no internationally recognised agreement on the form of RoO in PTAs. Each agreement has its own origin rules which are subject to detailed negotiations during its formation. Consequently, there is considerable variation in the way RoO are structured between agreements.

Multilateral trading arrangements under the World Trade Organization (WTO) do not need RoO because tariff regimes established under these arrangements are non-discriminatory (ie in the above example, and in the absence of CER, clothing from non-preferential sources outside the CER region as well as from New Zealand, would enter Australia at the scheduled MFN rate of 25 per cent).

## The CER RoO

Under CER RoO, goods wholly produced in Australia or New Zealand (including 'raw' materials and goods 'wholly' manufactured in Australia and New Zealand) are entitled to preferential tariff rates without further conditions.

For goods manufactured in Australia and New Zealand using inputs obtained from both inside and outside the CER area, the criteria governing preference (ie the RoO) are that:

- 'the last process of manufacture' must be performed by 'the manufacturer' in either Australia or New Zealand; and
- not less than 50 per cent of the 'factory cost' (including materials, labour and overheads) associated with that process must represent 'qualifying expenditure' (ie is incurred in Australia or New Zealand).

It is these requirements that are the focus of this report.

## Reasons for the study

This study stems from concerns that some Australian and New Zealand firms are having difficulty achieving the 50 per cent minimum content threshold set down under the CER to confer origin. More specifically, difficulties are arising from:

- progressive outdating of CER definitions and thresholds as increased specialisation in production, with inputs sourced worldwide, has tended to replace more self-sufficient, integrated plants that characterised industry at the inception of CER in 1983; and
- greater international success which has led to an increase in the scale of production, which in turn has reduced unit overheads and made it more difficult for some goods to meet the CER local value content threshold.

In addition, differing interpretations by Australian and New Zealand Customs authorities of some CER RoO provisions have complicated the task of complying with and administering the rules. For example, some changes agreed in a 1992 review of the CER were inadvertently implemented in different ways by Australia and New Zealand, leading to different treatments of identical transactions.

A parallel officials' review has been charged with formulating changes to overcome some of these operational problems. Some changes have been implemented already, as may others before consideration of this report by the Government.

## Preferential trading agreements

PTAs co-exist alongside multilateral arrangements instituted under the auspices of the WTO. They can be attractive because it may be easier for a small group of countries to agree on trade concessions than it is to reach agreement in a wider forum such as the WTO. Some commentators suggest that PTAs can offer new approaches to rule-making that supplement multilateral negotiations.

Australia's approach to trade reform has focused mainly on unilateral liberalisation, supported by its participation in the multilateral trading system under the GATT/WTO. The CER has been Australia's main bilateral trading agreement, but recently Australia has taken a more active interest in widening its involvement in PTAs. It has concluded an agreement with Singapore, and agreements with Thailand and the United States have been negotiated recently.

### *Significance of PTAs*

At the inception of CER in 1983, just over 20 PTAs were in force around the world, with the then European Economic Community (now the European Union) being the major regional agreement. However, the number of PTAs has increased substantially over the past decade. By 2003, 262 of these agreements had been notified to the WTO. The WTO estimates that 43 per cent of world merchandise trade now occurs under the umbrella of PTAs. Despite the rapid increase in the number of PTAs, however, the value of trade between PTA members has increased less rapidly than the total trade of those members.

### *Economic implications of RoO*

The key economic impact of preferential RoO is the incentive they provide for producers to substitute higher-cost inputs from member economies for cheaper or better quality imported inputs from non-members in order to qualify for concessional entry. These costs can outweigh gains associated with more liberal trade relations between members of a PTA. RoO can also adversely influence investment decisions and give rise to significant compliance and administration costs for business and government, respectively.

The impact of RoO depends on a range of global and national factors. For example, other things being equal, the economic costs are likely to rise the more RoO encourage 'trade diversion' away from least-cost sources. This will depend on factors such as:

- the margin between preferential tariff rates and MFN rates;
- the overall stringency of the criteria for conferring origin; and
- the extent to which prescriptive RoO are used merely to limit the effects of preferential tariffs to members of an agreement or to achieve industry policy objectives.

The increasing number of PTAs will result in diverse RoO, adding to the complexity and compliance costs of engaging in trade.

## CER and trans-Tasman trade

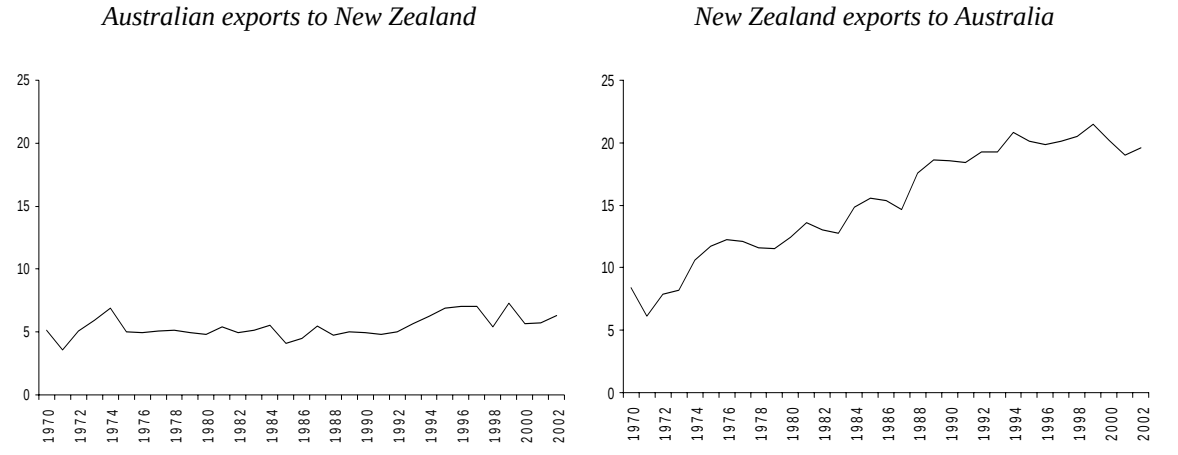
### *Trends in trans-Tasman trade*

The total value of Australia's exports to New Zealand is more than one-third greater than New Zealand's exports to Australia. The value of Australia's merchandise exports to New Zealand increased from nearly A$220 million in 1970 to nearly A$8 billion in 2002, while New Zealand exports to Australia increased from A$95 million to more than A$5 billion over the same period.

As growth in exports to other economies has also been substantial, the relative importance of the trans-Tasman trade has not increased proportionally. However, Australia is now a much more important market for New Zealand exports (relative to New Zealand's total exports) than New Zealand is for Australian exports.

**Trans-Tasman export shares**

Value share, per cent [a]




[a] The value of trans-Tasman exports expressed as a percentage of total merchandise exports.

In 2002:

- about 6 per cent of Australia's exports went to New Zealand, only fractionally above the 1970 level; while
- about 20 per cent of New Zealand's exports were to Australia, more than twice the 1970 contribution — reflecting a steady increase during the 30-year period.

### *How much CER trade is governed by RoO?*

CER RoO are only relevant when the MFN rate is above zero in Australia or New Zealand. In 2001, this was the case for 47 per cent of trans-Tasman trade.

Looking behind this aggregate, about one-third of Australia's exports to New Zealand and around two-thirds of New Zealand's exports to Australia attracted a MFN rate above zero and were eligible for concessional treatment — ie duty free entry — under CER.

Despite preferences available under CER, a small proportion of trans-Tasman trade enters at the MFN rate either because the merchandise has not satisfied origin requirements or because firms have opted not to apply for preferential entry (possibly on account of compliance costs).

### *How big is the margin of preference?*

MFN tariff reductions in Australia and New Zealand over the past 20 years have significantly reduced the duty concession (or 'margin of preference') afforded to CER trade. As the margin of preference continues to decline, so will the benefits and relevance of origin in trans-Tasman trade.

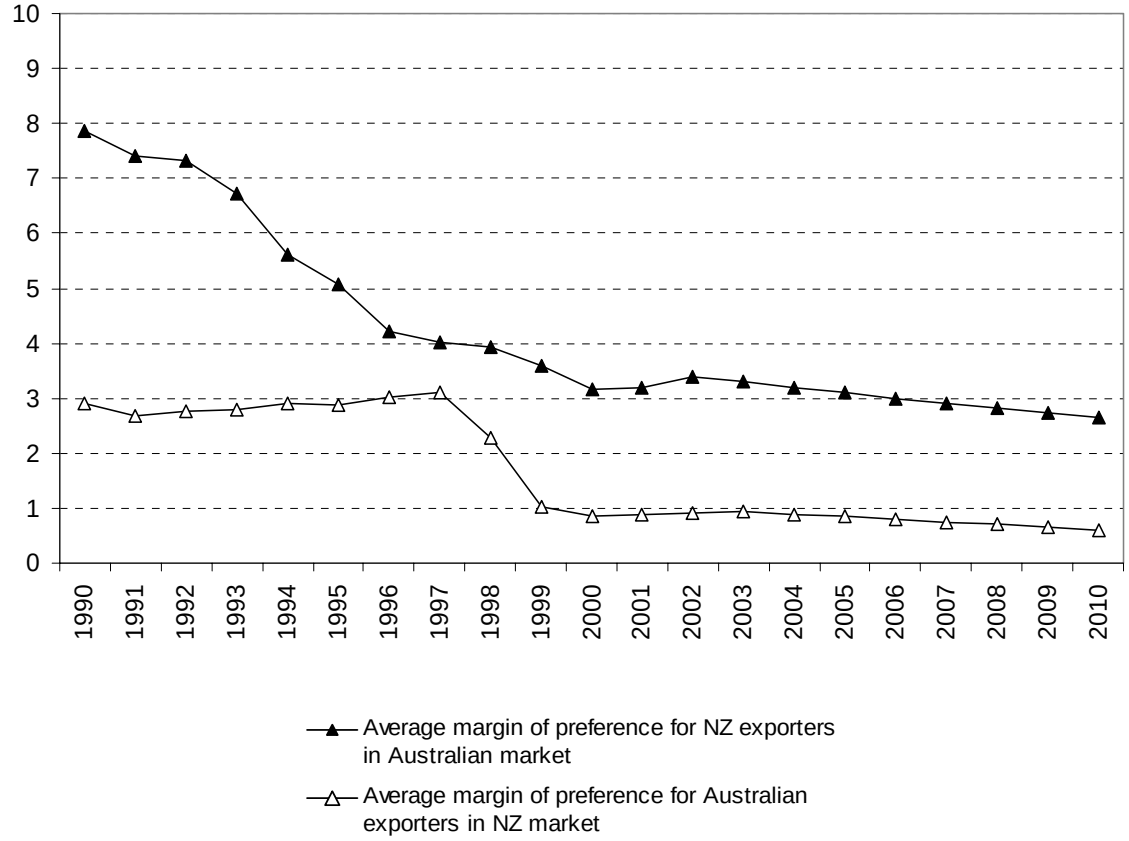
By 2002, the average margin of preference — measured as the difference between the MFN rate and the concessional rate (zero for all items since 1989) was:

- a little over 3 percentage points for New Zealand exports to the Australian market; and
- less than 1 percentage point for Australian exports to the New Zealand market.

For some goods such as textile, clothing and footwear items, where tariffs remain above average, CER concessions are still important. Scheduled reductions in these tariffs will, however, further reduce the significance of the CER RoO for these goods.

**Preferential margins within CER**

Tariff items average, per cent




*What is the assistance provided by CER?*

CER assists some producers while disadvantaging others. For example, Australian manufacturers of biscuits are currently protected against imports by a MFN tariff rate of 5 per cent, while the MFN rate in New Zealand is 7 per cent. Under CER, some local producers face increased competition from biscuits exported from New Zealand that can enter Australia duty free rather than having to pay the normal 5 per cent duty. On the other hand, CER enhances the competitiveness of those Australian firms that export biscuits to New Zealand, mainly because it affords them preferential (duty free) entry.

Estimates of 'additional' assistance afforded by tariff concessions to manufacturing outputs — which can be above or below that provided by the MFN rates in the local market — indicate that, overall, average output assistance provided by the Australian tariff to New Zealand exporters is higher than that provided by the New Zealand tariff to Australian exporters. This reflects generally higher MFN tariffs in Australia.

New Zealand firms therefore have, on average, greater incentive to adjust their CER content and production methods to meet CER RoO requirements than Australian firms. Again, scheduled tariff reductions will reduce these incentives.

## CER RoO problems and suggestions for change

By the standards of some other PTAs — such as those involving the United States or the European Union — the CER RoO are relatively 'clean'. That is, they are free of deliberately restrictive rules. Nevertheless, a number of firms and other interested parties expressed concern about the problems caused by CER RoO.

### *Concerns about the impact of RoO*

Some concerns have arisen from changes in the ways firms organise their production since the inception of CER, while others reflect rigidities inherent in the design of CER origin rules.

- Many firms expressed concern about the restrictiveness of the 'last place of manufacture' criterion. This criterion is quite well suited to integrated manufacturing processes which were relatively common at the inception of CER. It is not well suited, however, to current production systems which tend to be more specialised and often rely on contracting-out and commission work. This issue is presently being addressed by both countries.
- The definition of manufacturing has been determined by case law and has resulted in products being declared ineligible for preferential entry even though considerable value was added in member countries.
- Some firms (eg some clothing producers that use high-value imported materials) are finding it increasingly difficult to meet the 50 per cent CER content threshold. Measures to overcome this problem — such as the substitution of higher-cost or lower-quality local inputs to achieve local content — reduce firms' competitiveness. The present threshold also constrains the choices available to such producers about sections of the market in which they can compete.
- The CER content threshold also adds to uncertainty. In particular, some firms' ability to meet the threshold is sensitive to the price of materials, especially those that vary with changes in exchange rates and other factors beyond their control.
- Compliance costs incurred by firms in meeting the CER RoO requirements can be significant and in themselves can impede trans-Tasman trade. For example, some firms need supplementary accounting procedures to meet information requirements and monitor compliance with origin rules. While this may be relatively straightforward for some large or regular exporters, the task may discourage smaller or irregular exporters

from seeking preferential entry or, in some circumstances, entering the trans-Tasman trade.

### *Participants' views on change*

Some common themes emerged for and against change.

Overall, the majority of participants, including producers on both sides of the Tasman, advocated liberalisation of CER trade. However, some Australian firms, mainly in the TCF sector, supported retention of the current CER threshold to protect Australian activities from competition from New Zealand products (which can benefit from New Zealand's lower tariffs on fabrics and other inputs). Conversely, some Australian and New Zealand firms favoured lowering the 50 per cent CER content threshold because the nature of their inputs or operations, or the impact of exchange rate variations, threatens to take them below the CER content threshold.

A number of participants favoured moving from the current value content method for determining 'substantial transformation' to a change in tariff classification (CTC) method. Under this method, substantial transformation is deemed to have occurred if the finished good has a tariff classification different from that of the inputs used in its production. The method was suggested as a means of overcoming the compliance costs and lack of certainty and consistency associated with the present arrangements. Support for this method was more evident during the early stages of the study and, while some remained supportive of it, others sought either no change to the existing CER RoO or liberalisation within the current RVC framework.

Several participants who expressed a preference for CTC suggested that it be complemented by industry-specific local content thresholds or technical tests.

Other participants did not support a change to CTC because the broad definition of tariff items would not enable origin to be conferred on their outputs, whereas they comfortably satisfy the present CER content requirement. A further concern was that supplementary testing inherent in the application of the CTC method would negate its perceived advantages.

A common request was for rules to be applied in the same fashion in Australia and New Zealand to remove inequitable treatment of similar processes.

## Are changes warranted?

In assessing the efficacy of the present RoO and the case for change, the Commission has been mindful of a number of broader developments that need to be taken into account:

- tariff levels in both Australia and New Zealand are being reduced progressively over the life of the CER — the RoO should complement, not impede, this policy;
- as tariffs fall, the proportion of trans-Tasman trade affected by RoO also falls — indeed, further scheduled reductions could render the CER RoO virtually irrelevant in 5 to 10 years time; and
- any change would involve some transitional costs for many importers/exporters.

These considerations do not support the case for *radical* change — in particular, for a change in the underlying structure of the RoO.

This conclusion is reinforced by the significant shortcomings of alternative configurations of RoO, especially the CTC model. While it may be simple and clear for many products, intuitively appealing, favoured by a number of participants and the most common model in PTAs involving the European Union and the United States, its implementation is fraught with problems.

- Unlike the current CER RoO, the CTC method does not treat industries or products uniformly. This is because the extent of transformation involved in a change in tariff classification varies greatly between headings. As a result, it provides inconsistent origin determinations across industry sectors and can produce distortions in trade.
- Further, the origin rules for single products often differ between PTAs, adding to complexity and distortions in trade.
- The CTC method can be subject to manipulation to provide sectoral assistance with limited transparency. It can also require potentially time-consuming and costly negotiations with industries within the PTA partner countries.
- Its implementation typically involves the use of secondary criteria, such as sector-specific technical tests and regional value content rules. As experience with overseas PTAs based on CTC shows, these often add to protection levels and compliance costs.
- The classification is slow to adapt to changes in technology.

Furthermore, origin rules based on the CTC model differ significantly in detail. Indeed, there are many instances in which the rules for a particular product differ across CTC-based PTAs involving the same member. In these circumstances, the benefit to CER traders and Customs agencies from the adoption of this model would consequently be minor.

Because of these general considerations relating to the likely future role of RoO in CER, the maturity of the CER agreement and the inherent weaknesses of the CTC model, the Commission recommends that there be no shift from the current CER RoO framework (see recommendation 1). However, it considers that some changes within the existing CER RoO framework are warranted to promote efficiency and trade between the two countries.

## How should the RoO be modified?

To guide the assessment of options for change, some design principles have been developed.

Consideration of the design principles suggests that RoO should not be used:

- as a substitute for tariff assistance, particularly to compensate for increased competition arising from bilateral tariff reductions implemented through a PTA; or
- to implement specific industry policy objectives, such as encouraging investment in a particular activity or region.

**Rules of origin design principles**

To help ensure that the potential benefits from a PTA are fully realised, RoO should:

- include a clear and unambiguous statement of their objective;
- conform with the goals of the PTA;
- be consistent with the country's international obligations;
- avoid product-specific rules;
- avoid undue distortions in the allocation of resources and associated reductions in economic efficiency;
- facilitate organisational and technological innovation and the capacity of producers to respond to changes in consumer tastes;
- minimise compliance costs for industry;
- minimise administration costs for government;
- be certain and consistent in the determination of origin; and
- operate in a transparent and accountable manner.

Consistent with the trade liberalisation programs pursued by both governments and the objectives of CER itself, the Commission has drawn on the design principles to identify options that will facilitate trade, allow firms greater flexibility to adjust to changes in technologies and economic conditions, and reduce compliance costs.

### *Measures for the immediate future*

There is a number of measures that the Commission considers should be implemented in the immediate future to improve the efficiency and effectiveness of the RoO. These comprise some relatively minor changes in the RoO and a more substantial change to

address identified problems and to further reduce barriers to trade between Australia and New Zealand.

### *Minor changes*

The relatively minor changes involve amendment of the 'last place of manufacture' criterion, use of the definition of manufacturing contained in the Singapore–Australia Free Trade Agreement (see box) and alignment of the treatment of eligible costs between the two countries. The changes would overcome some operational problems and recognise changes in the ways firms now organise their production (eg greater use of sub-contracting arrangements) (see recommendation 2).

These changes would have useful but relatively modest economic effects. They would remove disincentives inherent in the present RoO to improve firm efficiency by reducing costs (eg by introducing new technologies or by outsourcing some production processes). To the extent that the changes ease the current restrictions on origin, there would be increased scope for efficient trans-Tasman trade. The proposal should also reduce compliance and administration costs.

**Singapore–Australia Free Trade Agreement definition of manufacture**

Manufacture means the creation of an article essentially different from the matters or substances that go into such manufacture and does not include the following activities (whether performed alone or in combination with each other):

(a) restoration or renovation processes such as repairing, reconditioning, overhauling or refurbishing;

(b) minimal operations; and

(c) quality control inspections.

### *Substantial change*

To achieve more significant progress in addressing the problems discussed in this report and further reduce barriers to trans-Tasman trade, the Commission recommends that a simple waiver rule be adopted to bypass the RoO regional content test when the MFN rates between Australia and New Zealand are closely aligned — the Commission recommends 5 percentage points difference or less — provided that the goods are manufactured in Australia or New Zealand (see recommendation 3).

A reduction in the regional value content threshold would also have trade-liberalising effects. This could be achieved by lowering the threshold under the CER from 50 per cent

to 40 per cent immediately. A further reduction to 30 per cent in 2010 could also be considered.

While lowering the RVC threshold would address some of the problems identified in this report, it would not overcome those stemming from the manner in which the threshold is calculated or the information burden associated with local content tests. The waiver would have more wide-ranging benefits and is the Commission's preferred approach to more substantial change. It would increase the range of goods eligible for duty free entry above what could otherwise be achieved. Indeed, after the scheduled January 2005 tariff reductions, the waiver would cover almost all trans-Tasman trade.

### *Economic impacts of the waiver*

The waiver would be implemented in an environment in which tariffs on inputs of materials in Australia and New Zealand differ and duty drawback on trans-Tasman exports favours exported goods over similar locally-produced goods. Differences in those tariffs and duty drawback have been features of the CER since its inception in 1983. Nonetheless, it was claimed by a few participants that, coupled with the proposed waiver, these factors would result in some trade flows that, from the perspective of Australia as a whole, would be inefficient.

This concern about the importance of different tariffs on inputs and duty drawback focuses only on the Australian domestic market and one *possible* outcome. There are, however, also a number of possible positive outcomes. These would lead to greater opportunities for Australian exporters in the New Zealand market, place CER exporters on a more equal footing with exporters from third countries who benefit from access to duty free inputs, and increase the efficiency of firms' purchasing decisions. These benefits would be enhanced by less restrictive RoO.

By addressing the problems of the CER RoO, the waiver would enable Australian and New Zealand firms to improve their underlying cost efficiency. The waiver would reduce the restrictiveness of the CER RoO and would benefit industries and consumers in both Australia and New Zealand. It would provide new opportunities for export-oriented firms and for new exports. By reducing the information needed to establish origin to a minimum, the waiver would also give rise to significant savings in compliance and administration costs for businesses and governments — in short, it would substantially alleviate the present regulatory burden.

### *How significant might adjustment pressures be?*

Some firms would face greater competition in the domestic market as a result of the waiver. Indeed, some textiles and clothing and chemicals and plastics participants

suggested that there could be significant increases in competition in some sections of the domestic market. However, the Commission considers that the scope for adverse impacts on Australian industries from New Zealand competition would be small, and largely confined to some firms and product lines.

For example, in the case of the TCF sector, the Commission notes the following.

- Additional competition from New Zealand initially would come from TCF firms already competing in the Australian market, but not presently benefiting from the CER concessions (ie now paying duty on imports). However, those imports are negligible — equivalent to less than one tenth of one per cent of Australian production of TCF goods.
- Additional competition would come also from firms which currently satisfy the regional content requirement and which would be able to change their purchasing decisions, production methods and product lines. New firms might also enter the trans-Tasman trade. As imports of TCF products from New Zealand are equivalent to a little under 5 per cent of Australian production of those products, even a large improvement in the competitiveness of New Zealand firms is likely to have only a modest impact on the Australian industry.
- Trans-Tasman transport and associated distribution costs would provide some measure of natural protection to local industry. Trade data indicate that trans-Tasman transport costs range between 3 per cent and 7 per cent of the dutiable value of goods.
- Were New Zealand goods to become more competitive in the Australian market as a consequence of the CER, they could take market share from third country imports rather than from Australian firms alone.

These considerations suggest that possible increases in TCF imports from New Zealand would be unlikely to cause significant adjustment pressures for the Australian industry as a whole. The Commission also notes that the post-2005 assistance package to the Australian TCF sector will provide transitional budget support of $747 million. No corresponding assistance is available to New Zealand firms.

There would be benefits accruing to Australian TCF firms from easier access to the New Zealand market. Increased opportunities provided by the waiver and associated productivity improvements could even offset the impact of additional competition from New Zealand.

In the Commission's judgment, any adverse effects of greater competition experienced by TCF or other activities would be outweighed by the benefits to exporters (including of TCF goods), user industries and consumers.

Adjustments that would arise from the introduction of the waiver and the other measures recommended in this report would be consistent with government initiatives to develop a single economic market comprising Australia and New Zealand.

### *Longer-term options*

In the longer term, there would be gains to both Australia and New Zealand from the closer alignment of their trade regimes, such that there would be little or no need for RoO and the economic and administrative costs associated with them. Two options that would achieve that goal would involve:

- removing the CER content threshold and retaining only the requirement that goods be manufactured in the region; and
- aligning all Australian and New Zealand tariffs (see recommendation 4).

The Commission considers that recommendations 1 to 3 should be implemented as soon as possible, while recommendation 4 should be considered before 2010.

# Recommendations

RECOMMENDATION 1

***The basic form of the CER RoO should remain unchanged. The change in tariff classification (CTC) model should not be used for origin determination under the CER.***

RECOMMENDATION 2

***The following changes should be made to address day-to-day shortcomings of the current CER RoO.***

- ***The 'last place of manufacture' requirement be replaced with one based on the 'principal firm', defined as the firm that performs, or has performed on its behalf, the last process of manufacture in the CER region.***
- ***A standard definition of manufacturing — that contained in the Singapore–Australia Free Trade Agreement (ie section 153UA of the Australian Customs Act 1901) — be adopted.***
- ***The valuation and coverage of eligible costs in Australia and New Zealand be aligned to achieve a single set of rules implemented according to uniform practices.***
- ***Legislation, regulations and Customs guidance manuals in Australia and New Zealand be aligned as far as practicable.***

RECOMMENDATION 3

***A 'waiver' should be introduced to provide automatic duty free entry to any goods:***

- ***manufactured within Australia or New Zealand (ie as defined in recommendation 2); and***
- ***for which the difference between the Australian and New Zealand MFN tariff rates is 5 percentage points or less.***

***A waiver, once granted, should not be removed.***

RECOMMENDATION 4

***Before 2010, consideration should be given to advancing the goals of the CER Agreement by:***

- ***elimination of the CER content threshold, with only a 'principal firm' manufacturing test being applied; and***
- ***alignment of remaining non-zero MFN rates in the Australian and New Zealand tariff schedules, so that ultimately merchandise from all sources enters each jurisdiction on a common basis.***

# Findings

The following are the Commission's findings.

## Chapter 2

*The share of global trade conducted under PTAs has increased substantially since the 1980s, largely as a result of the increased number of those agreements.*

*The expansion of PTA membership has not always increased the importance of intra-PTA trade relative to total trade by member countries. In fact, the value of trade between PTA members has increased less rapidly than the total trade of those members.*

*Average margins of preference in PTAs vary. The margins within CER are low, but are somewhat higher for New Zealand exporters than for Australian exporters.*

*Most trans-Tasman trade is duty free. More than half enters at a most favoured nation (MFN) rate of zero. Most of the remainder enters duty free because the goods satisfy the CER RoO.*

*Tariff schedules in Australia and New Zealand are closely aligned. Scheduled tariff reductions will increase the alignment. By 2010, all tariffs in Australia and New Zealand will be 10 per cent or less and scheduled rates on individual items will be within 5 percentage points of each other. The relevance of CER RoO is minimal and declining.*

## Chapter 3

*RoO are not needed where trade is free or where it is conducted on a non-discriminatory MFN basis.*

*PTAs typically use one or more of three general rules to determine the origin of goods. Implementation of each of these rules involves practical difficulties.*

*RoO for industries such as textiles, clothing and footwear and motor vehicles are often complex and restrict trade in these products. In doing so, they can preclude benefits that would otherwise be available to producers of finished products and to consumers.*

*International efforts to harmonise RoO have concentrated on non-preferential rules. Little progress has been made on the harmonisation of preferential RoO.*

## Chapter 4

*RoO enforce the discriminatory nature of a PTA. The economic impacts depend on how restrictive they are and the extent to which the external tariff regimes of the member countries differ. Highly restrictive RoO can erode the gains from lower tariffs in a PTA.*

*Compared with RoO in other PTAs, CER RoO are relatively 'clean' — that is, they are relatively free of deliberately restrictive rules.*

## Chapter 5

*Problems associated with the current CER RoO are of greater concern for Australian and New Zealand firms and industries that are export-focused. Many of the concerns relate to trade in TCF goods.*

*Some aspects of CER RoO — notably the valuation of materials supplied at less than market value — are not implemented consistently by authorities in Australia and New Zealand.*

*The definition of manufacture used in CER RoO is well established and has long been accepted. However, the application of the definition to particular cases can at times be difficult and is subject to case-by-case interpretation.*

*The concept of the last place of manufacture has lost some relevance because of changes in the way firms organise their production.*

*The CER content threshold of 50 per cent penalises the achievement of productivity gains by some firms. It can constrain firms' marketing options and adversely affect their competitiveness in other markets. Factors outside firms' control — such as exchange rate fluctuations — can make this rule difficult to satisfy.*

*It would not be appropriate to design rules of origin in such a way as to compensate for differences between input costs in Australia and New Zealand, irrespective of the cause of such differences.*

## Chapter 6

*Overseas research suggests that the annual costs of complying with RoO can range from 1.5 per cent to almost 6 per cent of the value of the products traded.*

*It is estimated on the basis of overseas research that the costs of complying with CER RoO are less than A$70 million per year.*

*Compliance costs take several forms and vary from company to company. Small, irregular exporters, in particular, might find them to be significant, to the point where some are discouraged from entering trans-Tasman trade or simply choose to pay the MFN tariff rate.*

*Multiple PTAs with different RoO add to compliance and administration costs. With differences in the 'fine print' between RoO based on the same model, these costs seem unavoidable.*

### Chapter 7

*To realise fully the potential benefits of bilateral tariff reductions from a PTA, RoO should be guided by a set of principles designed to ensure that the rules enhance the prospect of a PTA delivering net welfare gains to its member countries.*

*It would not be appropriate to use preferential RoO in trade agreements:*

- *as a substitute for tariff assistance, particularly to compensate for increased competition arising from bilateral tariff reductions implemented through the PTA; or*
- *to implement specific industry policy objectives, such as encouraging investment in a particular activity or region.*

### Chapter 8

*Because certain problems arise with each method commonly used to determine origin, there is no ideal solution to current concerns. Moreover, different RoO can result in different determinations of origin for a particular product. Consequently, any proposed changes will involve some compromises.*

### Chapter 9

*As tariffs in Australia and New Zealand continue to fall, it is possible that there will be no need for CER RoO in 5 to 10 years.*

*Consistent with the objectives of the CER Agreement, options for change should aim to facilitate a more open trans-Tasman market by reducing the trade restrictiveness which has developed in the existing RoO and the regulatory burden which they impose.*

*Adoption of the CTC model in non-CER agreements has been accompanied by substantial differences in origin rules, particularly for so-called 'sensitive' sectors.*

*Achievement of similar origin rules is likely to become increasingly difficult as Australia and New Zealand engage in separate, and sometimes overlapping, PTAs. A multiplicity of RoO raises transactions costs and increases the likelihood of distortions in, and restrictions on, trade.*

*The CER Agreement is mature. A very high proportion of trans-Tasman trade now takes place duty free. The costs of changing to a different model for determining origin would be difficult to justify.*

*A reduction of the regional value content threshold from 50 per cent to 40 per cent immediately, with a further reduction to 30 per cent in 2010, would help to address problems associated with the current RoO and to liberalise CER trade.*

*While priority should be given to the implementation of the waiver (recommendation 3), a reduction in the regional value content threshold would be beneficial, particularly while tariff differences remain greater than 5 percentage points.*

*The impacts of implementing a waiver are expected to be small in aggregate and for particular industries. Consequently, the likelihood of significant adjustment pressures is small.*

# 1 About the study

The purpose of this study is to examine Australia's rules of origin (RoO) arrangements under the Australia–New Zealand Closer Economic Relations Trade Agreement (CER) and to propose any changes needed to ensure that the RoO continue to promote the goals of the CER. It takes place at a time when both governments have been discussing measures necessary to move towards a single trans-Tasman economic market (Howard 2004, Costello 2004).

This chapter provides information on the evolution of the CER and its RoO. It also places the CER in the context of the international trading system and related policy developments before outlining the structure of this report.

## 1.1 Background

The Australia–New Zealand Closer Economic Relations Trade Agreement (CER) entered into force in 1983, building on earlier preferential trade agreements between the two countries.[1] Its objectives, as listed in Article 1 of the Agreement, are to:

- strengthen the broader relationship between Australia and New Zealand;
- develop closer economic relations through a mutually beneficial expansion of free trade between the two countries;
- eliminate barriers to trade between Australia and New Zealand in a gradual and progressive manner and with a minimum of disruption; and
- develop trade between New Zealand and Australia under conditions of fair competition.

By June 1990, all tariffs and quantitative restrictions on trade between Australia and New Zealand which met the CER rules of origin were eliminated, ahead of the schedule laid

[1] Following an unsuccessful attempt to establish a preferential trading arrangement between the two countries in 1906, Australia and New Zealand signed their first trade agreement in 1922. In 1965, the New Zealand–Australia Free Trade Agreement, the predecessor of CER, was formed. By the late 1970s, tariffs and quantitative restrictions had been removed on about 80 per cent of trans-Tasman trade. Further advances were limited because of the lack of an agreed mechanism for removing the remaining restrictions. Of concern to Australia were the import licensing restrictions remaining in New Zealand which, in many cases, effectively negated the benefits derived from removing tariffs.

down in 1983. Reviews of the CER in 1988, 1992 and 1995 also widened its scope to include trade in services and to harmonise a range of trade-related matters in the areas of quarantine, customs, standards and business law.[2]

Review of the operation of the CER now takes place as part of annual Australia–New Zealand Trade Ministers' meetings.

## 1.2 The reference

The terms of reference for this study were announced at the time of the Trade Ministers' meeting in August 2003. Broadly, the reference asks the Commission to:

- identify any economic and administrative problems with the operation and design of the rules of origin;
- propose any changes, including design or model changes, to ensure that the rules of origin continue to promote the goals of the CER;
- assess the costs and benefits, including the regulatory burden, of any proposed changes; and
- consider relevant international developments.

The full terms of reference are on page iv.

The study stems from concerns of Australian and New Zealand firms that are having difficulty achieving the minimum content threshold set down under the CER rules of origin (Campbell 2003).

## 1.3 Outline of the CER RoO

Broadly, the rules of origin (RoO) under CER establish criteria to determine which goods have sufficient Australian or New Zealand content to be accorded preferential tariff treatment under CER.

To this end, goods are divided into three categories:

1. goods wholly the produce of Australia or New Zealand (unmanufactured raw products);
2. goods wholly manufactured in either country from one or more of the following:

[2] Developments during this time included the Trans-Tasman Mutual Recognition Arrangement, the establishment of a single aviation market, a trans-Tasman food standards body (Food Standards Australia New Zealand) and arrangements to reduce border inspection requirements for food products originating in either country.

(a) unmanufactured raw products (of any country);

(b) materials wholly manufactured in Australia or New Zealand or both;

(c) materials determined to be raw materials of Australia/New Zealand; and

3. goods partly manufactured in the country.

Goods in categories 1 and 2 are entitled to preferential rates of duty without further conditions. However, for category 3 — goods manufactured in Australia or New Zealand using inputs obtained from both inside and outside the CER area — the criteria governing preference (ie the RoO) are that:

- 'the last process of manufacture' must be performed by 'the manufacturer' in either Australia or New Zealand; and
- not less than 50 per cent of the 'factory cost' must represent 'qualifying expenditure'.

In essence, 'manufacture' is considered to involve the creation of an article different from the component parts or materials used in the article. Consequently, repairing, reconditioning, overhauling or refurbishing are deemed not to constitute manufacture; they are regarded as restoration processes. In addition, minimal operations or processes such as pressing, labelling, ticketing, packaging, preparation for sale and quality control inspections are not, by themselves, considered to be manufacturing processes.

It is the requirements of category 3 that are the concern of much of this report. In part, this reflects changes in the way manufacture is now undertaken, compared with 1983 when the CER was established. In particular, at that time integrated manufacturing in a single location using locally-obtained inputs was the most common form of organisation. It is now much more likely that manufacture will be geographically fragmented, with inputs obtained worldwide as producers seek to obtain lower-cost or better quality materials. There are also concerns about what items of expenditure should properly be considered in an assessment of origin.

Details of the CER RoO, including the views of participants, are outlined in later chapters.

## 1.4 CER in the context of the international trading system

The CER is a preferential trade agreement (PTA). PTAs comprise the main exception to the most favoured nation (MFN) principle, which is the core of the multilateral trading system. This principle requires members of the World Trade Organization (WTO) to give fellow members no less favourable treatment in terms of tariff rates and other trade measures than they afford to any other country.

PTAs — termed *regional trade agreements*[3] by the WTO — are conditionally permitted by Article XXIV of the General Agreement on Tariffs and Trade, provided that they perform a trade-liberalising function and do not encourage the establishment of new barriers or provide an easy route to introduce new measures that discriminate between trading partners. The crucial test is whether the agreement eliminates tariffs and other restrictions on 'substantially all the trade' in goods between its member countries (although WTO members have differing opinions on how to define 'substantially all the trade').[4]

Countries enter into PTAs for many reasons. A primary reason is to permit member country exporters to have easier access to each other's markets. Another objective might be to protect their exporters from losing out to foreign companies in markets where other countries have negotiated preferential treatment under other PTAs. For example:

> … some supporters of a US–Chile FTA have argued that US firms are at a disadvantage vis-a-vis their Canadian competitors whose exports face no Chilean tariffs under the Canada–Chile FTA. (Cooper 2002, p. 3)

Alternatively, they may be motivated by underlying political or strategic considerations.[5] For example, the first objective of the CER is to 'strengthen the broader relationship' between the two countries. As the OECD observed:

> ... all [PTAs] are driven in large measure by geo-political considerations. Their role in the trading system, though crucial for trade policy, will always be seen by the participating governments in the broader context of the political and strategic objectives that the agreements seek to serve. (2003a, p. 7)[6]

The Australian Government considers that comprehensive PTAs can complement and provide momentum to multilateral trade objectives (box 1.1).

Others, however, fear that PTAs reduce the momentum for multilateral liberalisation and might make it more difficult in the future. (For recent statements of this view, see Bhagwati 2002, Findlay 2002 and Garnaut 2003a.) While acknowledging that PTAs can contribute towards convergence in multilateral approaches, commentators such as Garnaut cautioned that, for Australia:

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3 As Bhagwati (2002) pointed out: 'These are misleadingly called *regionals* by many — but … what is regional when Singapore or Israel goes with the United States?' (p. 113). Agreements may also be referred to as 'free trade agreements', which can likewise be misleading in view of the selectivity of such agreements and the extent to which they can distort some purchasing decisions.

4 Agreements may eliminate trade barriers immediately or phase them out over time.

5 Cooper argued that the United States entered into PTAs with Israel and with Jordan 'to reaffirm American support of those countries and to strengthen relations with them' (2002, p. 3).

6 A list of motives for the spread of 'regionalism' is given in OECD (2003a, p. 2).

> It is hard to imagine gains from bilateral FTAs with currently contemplated partners that could compensate for the losses that would be associated with a significant weakening of [the multilateral trading system]. (Garnaut 2003b, p. 17)

More generally, the OECD has said:

> ... the patchwork of regional initiatives may also give rise to systemic frictions because of divergence both among [PTAs] and with WTO agreements. (2003a, p. 5)

**Box 1.1 Australia's attitude to preferential trade agreements**

The Australian Government has said that it is:

> … open to concluding regional or bilateral agreements that deliver substantial gains to Australia and which cannot be achieved in a similar timeframe elsewhere.

The crucial test is seen as being that the agreement must eliminate all tariffs and other restrictions on substantially all the trade in goods between its member countries:

> … at the very least … a high proportion of trade between the parties … should be covered by the elimination of tariffs and other restrictive trade regulations. Australia considers that this must be a very high percentage, and that no major sector should be excluded …

The Government expects that progress in regional trade liberalisation will lead to multilateral liberalisation in due course through WTO negotiations. It is concerned, however, that:

> … existing WTO rules are not clear and therefore do not serve as an effective guide to countries entering into preferential trade agreements.

In the Government's view, the WTO rules should set a high standard for regional trade agreements, particularly if they are to complement multilateral trade negotiations. Such agreements should be comprehensive and address all sectors, 'including sensitive ones'.

*Source:* DFAT (2003).

Some commentators see slow progress in multilateral trade negotiations as providing an impetus for countries to enter into PTAs. Cooper (2002, p. 3) argued that the lack of progress at various times during the Uruguay Round negotiations (1986 to 1994) provided the impetus for the United States, Mexico and Canada to form NAFTA. In his view, it is arguable that the surge in formation of PTAs in recent years has been a result of the difficulties in launching a new round in the WTO. The breakdown of negotiations at the Cancun summit in 2003 is relevant in this context.

The impact of PTAs — together with associated regulation, such as origin rules, to enforce their discriminatory nature— has become much more important in recent decades, as reflected in a large increase in the number of PTAs (chapter 2).

## Australia's preferential trade agreements

Apart from CER, Australia has long-standing preferential trading agreements with various countries.

- Non-reciprocal agreements with the South Pacific Forum Island Countries (SPARTECA) and with Papua New Guinea (PATCRA II)[7] provide for duty free entry into Australia of goods meeting the rules of origin (based around a 50 per cent local content requirement).
- Australia also provides tariff preferences for some products under the Canada–Australia Trade Agreement, although this agreement is now largely redundant.[8]
- Many goods originating in developing countries attract preferential rates of duty under the Australian System of Tariff Preferences. (These preferences are also subject to a 50 per cent local content threshold.)

With only minor differences, the RoO in all of Australia's current preferential trade agreements rely on essentially the same regional value content method as applies under CER to determine origin and, hence, eligibility for entry at preferential rates. For example, under the agreement with Singapore, which became operational in July 2003, origin is generally conferred where local content of 50 per cent is achieved. For a limited number of electrical and electronic products, and for products subject to tariff concession orders, the local content threshold is 30 per cent.

However, Australia has recently completed negotiations for free trade agreements with the United States and with Thailand. While approval processes for both agreements are yet to be completed, the RoO for each are intended to be based on the change in tariff classification method (chapter 3), albeit modified to reflect the particular circumstances of the individual trade and investment relationships of the countries involved.

The principal concern of this study is not with the general issue of PTAs, nor with the general issue of the design of RoO across PTAs. Its focus is on CER origin rules. Nevertheless, the terms of reference require the Commission to take account of relevant international developments. Those relating to the spread of overlapping PTAs and associated origin rules are relevant to this study.

[7] Papua New Guinea is also a member of SPARTECA.

[8] While this agreement does not include rules of origin, Australia continues to offer preferential rates based on the rules of origin that governed the British Commonwealth preference system.

## 1.5 Parallel study

At their meeting in August 2003, the Australian and New Zealand Trade Ministers agreed that officials should examine the RoO under CER to consider whether improvements should be made. They directed that officials be guided by the following principles:

- RoO should continue to facilitate trans-Tasman trade in goods manufactured in the Free Trade Area and recognise the changed economic drivers as both economies seek to become more internationally competitive.
- All genuine local content should be counted towards meeting the RoO.
- The RoO should not act as a constraint on the development of innovative and efficient business practices within Australia and New Zealand.
- There should be equity of treatment for all businesses, whether they are integrated manufacturers or use outsourced manufacture.
- The RoO need to be able to be administered effectively and consistently by the Customs Services of Australia and New Zealand (Vaile and Sutton 2003).

Officials have also been directed to identify other issues for 'potential early harvest'. Ministers suggested that such issues might include:

- the sensitivity of the current RoO to exchange rates;
- the way overheads are apportioned; and
- the equity of treatment between integrated and outsourced operations.

Ministers have agreed in principle to a number of 'incremental improvements' to be designed 'without delay', including equity of treatment for outsourced manufacturing processes in both countries.

A Joint Customs Committee has also been established to ensure a harmonised approach to administration of the RoO.

Officials have presented interim reports to the Ministers and their final report, due in mid-2004, is to include recommendations on a possible comprehensive package of reforms. This process has taken place in parallel with the Commission's review.

## 1.6 Conduct of this study

The reference was received on 28 August 2003. The study was advertised widely in Australian and New Zealand newspapers and details were placed on the Commission's website. Possible interested parties were contacted by circular, email or telephone.

During August and September, the Commission visited a selection of firms and organisations in Australia and New Zealand to discuss their views on issues relevant to the terms of reference.

The Commission also invited participants to provide public submissions on any matter they considered to be relevant to the terms of reference. By early December, 25 submissions had been received. All public submissions were made available for others to read, including by way of the Commission's website.

On 22 December, the Commission released an interim report for public comment. The report contained analysis, findings and proposals for change. Copies were made widely available to interested parties.

During February 2004, roundtable discussions were held in Melbourne, Auckland, Wellington and Canberra, which were well attended. The Commission invited public submissions on the interim report and its proposals, and by May 2004 a further 22 public submissions had been received.

A list of visits and submissions is contained in appendix A. The Commission thanks all those who contributed their views or provided information to this study.

## 1.7 Structure of the report

The remainder of this report is structured as follows:

- Chapter 2 provides some context for the report by outlining trends in global trade, especially that conducted under preferential agreements, as well as trends in trans-Tasman trade.
- Chapter 3 considers the role of RoO and the various forms which they can take.
- Chapter 4 provides an overview of the economic impacts of RoO, focusing on trade and investment effects.
- Chapter 5 discusses the problems faced by firms on both sides of the Tasman in meeting the current rules for preferential entry under CER.
- Chapter 6 reports on the costs faced by firms in complying with those rules and the costs incurred by Australian and New Zealand Customs in administering and auditing them.
- Chapter 7 formulates some general principles to guide the design of RoO, with a view to minimising the costs to the community.
- Chapter 8 looks at various ways in which origin can be assessed, and outlines the advantages and disadvantages of each method.

- Chapter 9 draws on the assessment in chapter 8 and recommends changes to CER RoO.

# 2 Trends in preferential trade

Preferential trade agreements (PTAs), which exist alongside the multilateral agreements operating under the World Trade Organization (WTO), have expanded in number in the past decade. More agreements are expected. With this expansion, the potential importance of RoO in international trade has also increased. On the other hand, as tariffs decrease, the benefits of preferential access and hence the importance of RoO also decline. This has been the case for the CER over the past two decades.

The spread of PTAs and trends in preferential trade are outlined in this chapter to provide some context for the assessment of the design and operation of preferential RoO. Trends in CER trade are also outlined.

## 2.1 Global trends in preferential trade

### Preferential trade agreements

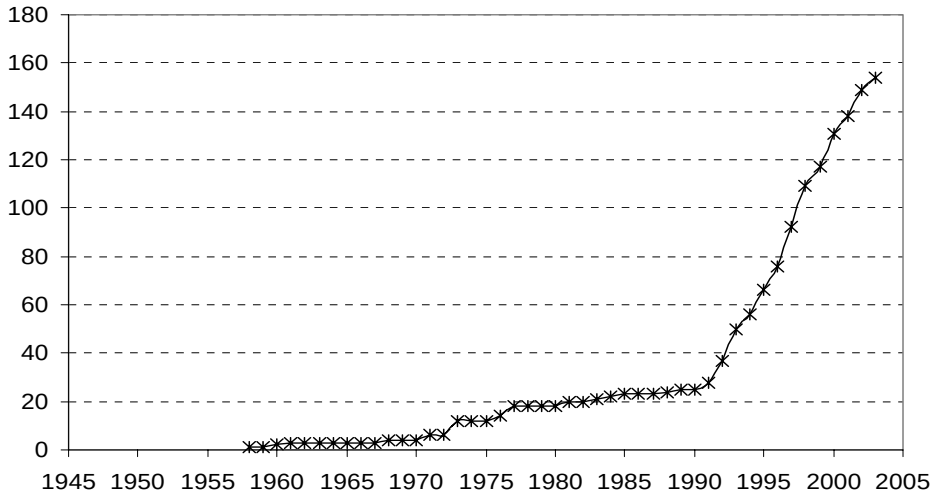
Until relatively recently, the number of preferential agreements was small. Most world trade was conducted on a non-preferential — or most favoured nation (MFN) basis — whereby a common tariff was applied to imports from all countries. Since 1990, however, the global trading system has seen a very substantial increase in PTAs (figure 2.1).

Australia, which until recently was a member of only three PTAs (PATCRA, SPARTECA and CER), has completed an agreement with Singapore and has recently completed negotiations for PTAs with the United States and with Thailand (although approval processes for both agreements are yet to be completed). The Australian Government has also signalled an interest in PTAs with Japan and China.

By the end of October 2003, 262 PTAs had been notified to GATT/WTO (WTO 2003f). Of these, 154 are currently in force (see appendix B). The increase in the number of PTAs raises the potential for diverse and overlapping agreements with various types of preferential RoO.

Figure 2.1 **Number of PTAs**

Number and date of entry into force




*Source:* WTO (2003e).

Together with the global fragmentation of production and increases in intra-industry trade (as firms seek to obtain the benefits of specialised production), the proliferation of PTAs and associated RoO has the potential to influence trade relations between countries significantly and add materially to compliance and administrative costs incurred by businesses and government. Lloyd (2001) noted that:

> It is the conjunction of increasing preferential trade and increasing fragmentation of trade that has made the problems of rules of origin more important in world trade. Increasing fragmentation has made the determination of origin more difficult and arbitrary. (pp. 275–276)

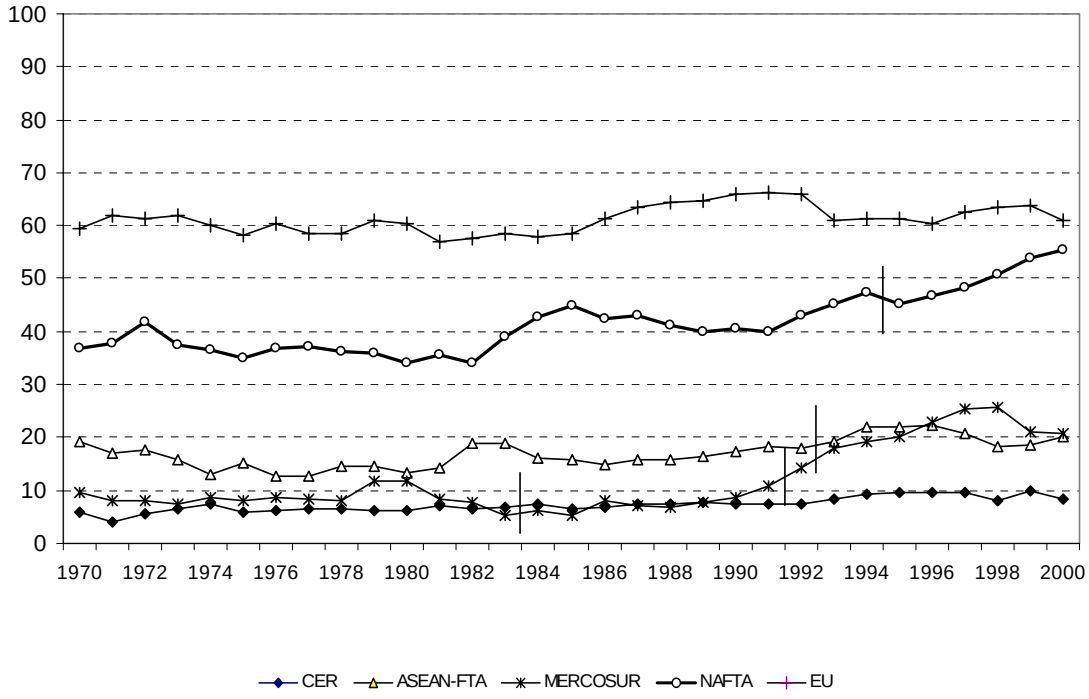
## Share of global merchandise trade conducted under PTAs

With the spread of PTAs, there has been a significant increase in the share of global exports contributed by countries that are PTA members — up from about 50 per cent in the mid-1980s to around 75 per cent in 2000.[1] Economies covered by some of the oldest and largest trade agreements — the EC/EU and EFTA agreements — contributed around 40 per cent of global exports. The main reason for the increased share of trade contributed by PTA countries was the formation of new agreements (such as NAFTA in 1994). Their prevailing high share of world trade points to the potential influence that PTAs can have on trading relations between countries — including between member and non-member countries.

[1] This percentage will have since increased, as Japan entered into its first PTA in 2002.

PTA membership or the establishment of a trading agreement is not necessarily associated with a widespread increase in the importance of trade between member economies (figure 2.2). For instance, intra-PTA export shares as a percentage of all exports by EU, ASEAN–FTA and CER economies have remained relatively constant over the last 30 years. For NAFTA economies, intra-regional export shares have shown an upward trend since the early 1980s — well before NAFTA entered into force in 1994. However, the trend intensified after 1994. Intra-PTA export shares for MERCOSUR economies also increased sharply after their agreement came into force in 1991.

Figure 2.2 **Intra-PTA export shares of major PTAs [a, b]**




**a** The sum of exports from PTA member economies to other member economies expressed as a percentage of total exports of member economies. **b** Member economies in EU comprise Austria, Belgium, Luxembourg, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Netherlands, Portugal, Spain, Sweden and the United Kingdom. Member economies in NAFTA comprise Canada, Mexico and the United States. Member economies in ASEAN-FTA comprise initial members (excluding Brunei Darassalam) Indonesia, Malaysia, Philippines, Singapore and Thailand.

*Sources:* Estimates based on WTA (2003) and WTF (2000).

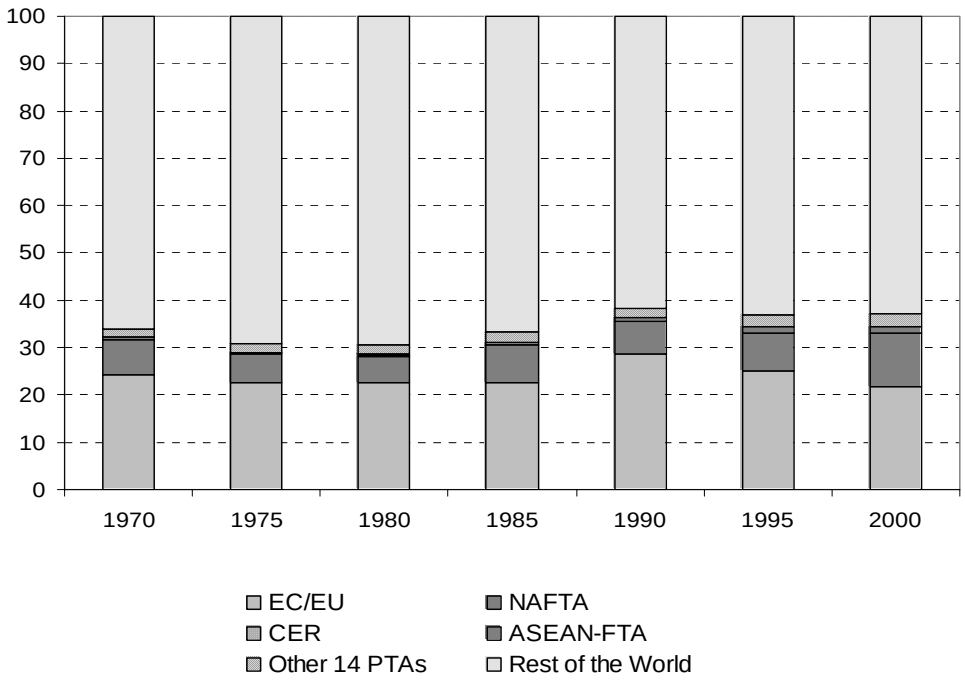
The share of total exports from Australia and New Zealand — the CER economies — entering the CER trade has remained fairly stable at below 10 per cent of the combined exports of Australia and New Zealand.

Overall, there appears to be no consistent pattern between the formation of a PTA and the extent of trade between PTA member economies. Even when there is an association with increased trade between economies and the formation of the agreement, the association

does not necessarily imply causality. Other factors may be at work, such as general micro-reform programs (eg unilateral MFN tariff reductions and other trade reforms, and competition policy reforms) and improved macroeconomic stability.

Nevertheless, as would be expected with the spread of PTAs, the relative importance of intra-PTA trade has increased. For example, export data for member countries of eighteen major agreements indicate that intra-PTA trade increased from around 33 per cent of global exports in the mid-1980s to 38 per cent in 2000 (figure 2.3).

Figure 2.3 **Global share of intra-PTA exports in major PTAs[a, b, c]**




**a** Where a PTA came into force during this period, the figure shows trade between the PTA member countries for the full period. **b** The sum of intra-PTA exports from PTA member economies expressed as a percentage global exports. The 'other fourteen PTAs' include: ANDEAN, Chile–US, Chile–MERCOSUR, EFTA, EU–Egypt, EU–Mexico, EU–Poland, MERCOSUR, US–Israel, US–Singapore, US–Jordan, Singapore–New Zealand, SPARTECA and Singapore–Australia. **c** CER intra-PTA exports were 0.1 per cent of global exports and therefore are not visible in the figure.

*Sources:* Estimates based on WTA (2003) and WTF (2000).

A WTO (2003f) study of 113 agreements reported that:

> … 43 per cent of world merchandise trade now occurs under the umbrella of preferential trade arrangements. This share will increase as more RTAs [PTAs] are negotiated in the future. If all RTAs [PTAs] under negotiation at present are successfully concluded within the next three years, over 50 per cent of world merchandise trade will then occur among countries linked by preferential agreements. (p. 48)

Because, under a PTA, trade can be diverted from low-cost non-member sources to higher-cost sources within that PTA region, the impact of PTA arrangements on global trade is likely to be much greater than that indicated by the scale of intra-PTA trade alone.

FINDING

*The share of global trade conducted under PTAs has increased substantially since the 1980s, largely as a result of the increased number of those agreements.*

FINDING

*The expansion of PTA membership has not always increased the importance of intra-PTA trade relative to total trade by member countries. In fact, the value of trade between PTA members has increased less rapidly than the total trade of those members.*

## Preferential market access in selected PTAs

Table 2.1 provides information on the incidence of duty free tariff items under MFN and preferential arrangements, average MFN and preferential tariff rates and the margin of preference for members of four PTAs, including CER (box 2.1).

### Box 2.1 Margin of preference

The 'margin of preference' for a PTA member is a measure of the difference between MFN and preferential tariff rates in a PTA economy (Estevadeordal 2000 and WTO 2003f). A margin of preference of zero indicates that the MFN and preferential rates are the same and origin would play no part in the purchasing decisions of importers. A positive margin of preference indicates that the MFN rate exceeds the preferential rate, and origin would play a part in those decisions. The higher the margin of preference, the more important determination of origin is for decisions about purchasing.

RoO are not relevant for items with an MFN tariff of zero. The proportion of such items varies considerably between economies. For example, in New Zealand, duty free MFN tariff items comprise 65 per cent of total items, while in Australia and Canada nearly 50 per cent of tariff items are duty free. Only a small proportion of tariff items had MFN rates of zero in Argentina and Uruguay. In the case of Mexico, there were none.

Table 2.1 **Average preferential treatment within selected PTAs**

Estimates for the end of the implementation period

| | | *Duty free tariff items (% of total)* | | *Average applied tariff (unweighted)* | | |
|---|---|---|---|---|---|---|
| *PTA / Importing country* | *Year* | *MFN* | *Preferential* | *MFN [A]* | *Preferential [B]* | *Average margin of preference [A-B]* |
| ***CER***[a] | | | | | | |
| Australia | 2000-01 | 47 | 96 | 3.3 | 0.08 | 3.2 |
| New Zealand[b] | 2000-01 | 65 | 85 | 0.9 | 0.00 | 0.9 |
| ***NAFTA***[c] | | | | | | |
| Canada | 2000 | 49 | 93 | 4.4 | 0.5 | 3.9 |
| Mexico | 1997 | 0 | 49 | 15.5 | 4.0 | 11.5 |
| USA | 2000 | 35 | 95 | 4.6 | 0.3 | 4.3 |
| ***MERCOSUR*** | | | | | | |
| Argentina | 2000 | 5 | 100 | 13.3 | 0.1 | 13.2 |
| Uruguay | 2001 | 5 | 99 | 12.3 | 0.1 | 12.2 |
| ***ASEAN*** | | | | | | |
| Malaysia | 2001 | 58 | 60 | 9.2 | 3.9 | 5.3 |

[a] Because duty is paid on some items of trade, the proportion of items obtaining preferential entry is less than 100 per cent. Duty may have been paid because the exporter did not apply for the concession or did not meet origin requirements. [b] Duty is not collected on some MFN imports into New Zealand because of the operation of permanent commercial tariff concession orders. The proportion of items with an applied MFN rate of zero is estimated after allowing for such tariff concession orders and the average MFN duty rates are estimated on the basis of duty collected on MFN imports. [c] For NAFTA, the reported rates are simple average applied tariffs across products and the NAFTA members. Weighted averages across all products are 0.7, 5.8 and 0.5 per cent for Canada, Mexico and the US, respectively.

*Sources*: Australian Customs Service (2003d), NZS (2003) and WTO (2003f).

As would be expected, the proportion of items that enable duty free entry under preferential arrangements is typically well above the incidence of items entering duty free on an MFN basis (table 2.1). An exception is Malaysia, where the incidence of duty free items is similar for PTA economies and other economies. This is because, under the ASEAN agreement, preferential trade liberalisation to date has been very limited. On this point, WTO (2003f) reported that:

> Within ASEAN about 66 per cent of tariff lines have the same MFN and CEPT [common effective preferential tariffs] rates. As far as the remaining one third of tariff lines is concerned, since many ASEAN countries have also autonomously reduced their tariffs in the 1990s, the difference between MFN and CEPT rates is small. Given the rules of origin of 40 per cent ASEAN content, traders may not have found the difference worth the cost of retooling their production to meet the content requirement. (pp. 54–55)

The extent of the preference margin varies considerably across PTAs. For example, the margin is relatively low in the ASEAN economy of Malaysia, reflecting relatively low average MFN rates (including zero rates). On the other hand, the margin of preference for MERCOSUR economies — Argentina and Uruguay — is relatively high, reflecting higher average external tariffs and a predominance of zero rates for preferential trade.

FINDING

*Average margins of preference in PTAs vary. The margins within CER are low, but are somewhat higher for New Zealand exporters than for Australian exporters.*

The margin of preference also varies within PTAs. For example, within NAFTA, the average preferential tariff on imports to the United States was 0.3 per cent against an average MFN rate of 4.6 per cent, indicating a relatively small margin favouring partner economies. On the other hand, for Mexico, the rates were 4 per cent and 15.5 per cent, respectively, indicating a relatively large preference margin favouring imports from partner economies.

Within the CER, MFN tariffs in Australia are higher on average than those in New Zealand. While most trans-Tasman trade is duty free, the margin of preference afforded to New Zealand imports from Australia is higher than the margin of preference on Australia imports from New Zealand. Reflecting their lower average MFN tariffs, the CER economies have lower preference margins than key economies in other agreements.

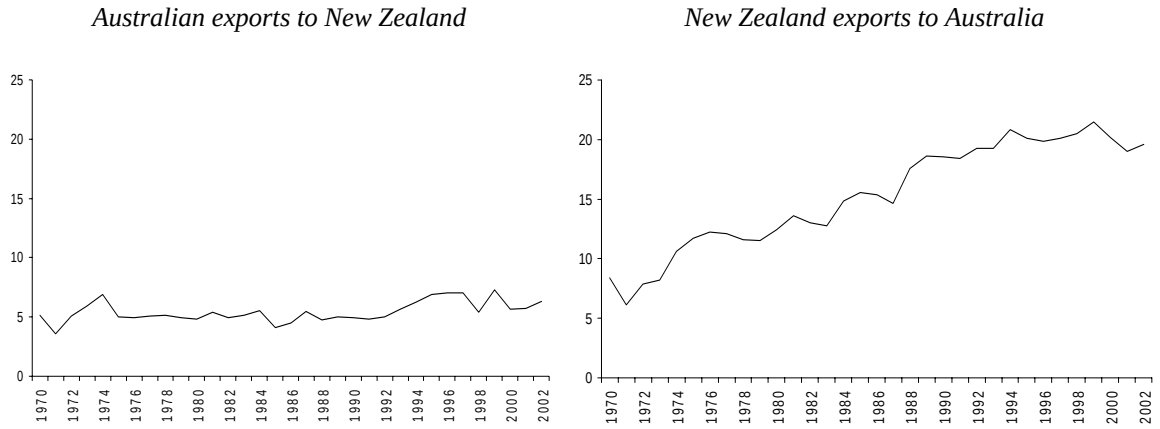
## 2.2 Trends in CER trade

The value of Australian exports to New Zealand exceeds the value of New Zealand exports to Australia, but the latter has been growing faster. Australia's merchandise exports to New Zealand in nominal terms increased from almost A$220 million in 1970 to nearly A$8 billion in 2002. Over the same period, New Zealand merchandise exports to Australia increased from A$95 million to more than A$5 billion. However, Australian and New Zealand exports to other economies have also grown substantially, so that the relative importance of trans-Tasman trade has not increased significantly.

Australia is a more important market for New Zealand exports than New Zealand is for Australian exports (figure 2.4). Over the past thirty years, the value of Australian exports to New Zealand, as a proportion of its total exports, has been relatively steady at just above 5 per cent. On the other hand, the proportion of New Zealand exports to Australia has increased steadily, from 8 per cent in 1970 to 20 per cent in 2002.

Figure 2.4 **Share of trans-Tasman exports in total Australian and New Zealand exports**

Value share, per cent [a]




[a] The share represents the value of trans-Tasman exports expressed as a percentage of total merchandise exports.

*Sources:* Based on WTA (2003), WTF (2000), ABS (2004) and NZS (2004).

## 2.3 The changed tariff environment for CER

### Preferential treatment within the CER

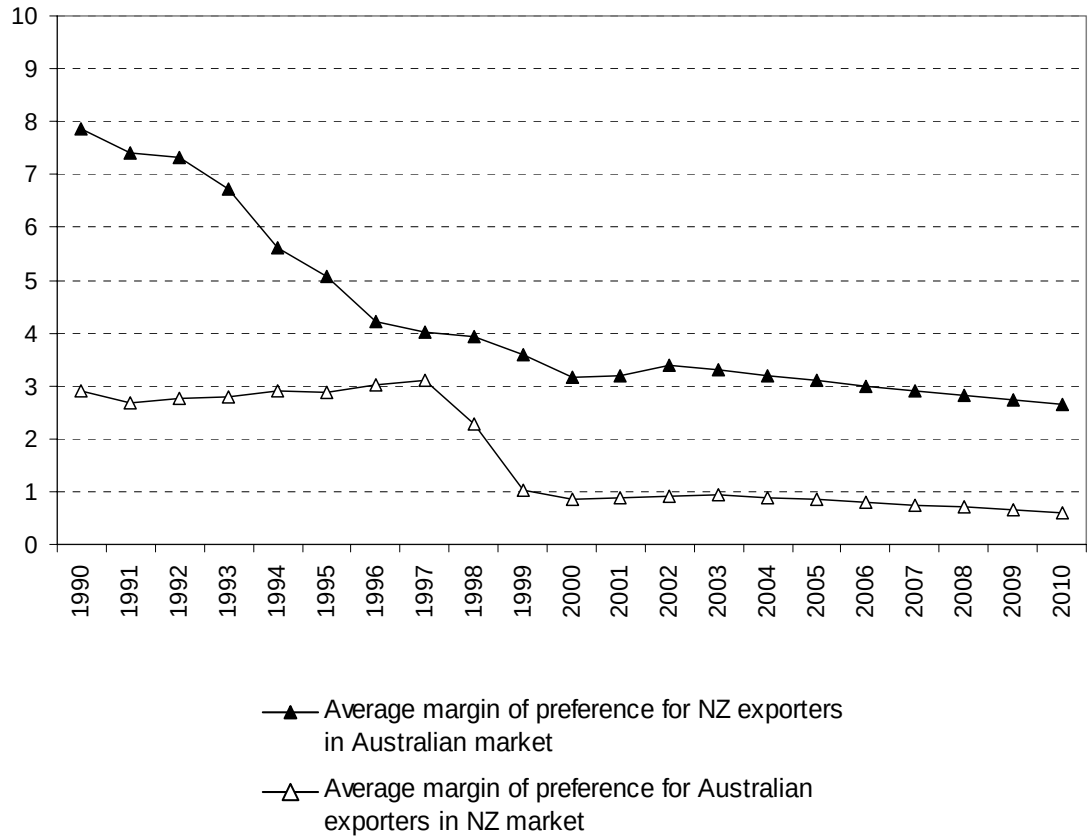
By 1990, all concessional rates within CER had been reduced to zero. Subsequently, as the MFN tariffs in both countries were reduced during the 1990s (and trade in low-tariff items increased), the average margin of preference also declined (figure 2.5). In particular, the average MFN rate for Australia declined from more than 8 per cent in 1989-90 to a little over 3 per cent in 2000-01, while the average rate for New Zealand declined from more than 3 per cent to less than 1 per cent. As a result, the margin of preference afforded to New Zealand exporters declined more than the margin of preference afforded to Australian exporters. Nevertheless, because average MFN rates remained higher in Australia than New Zealand, the average margin of preference for New Zealand firms exporting to Australia in 2002 remained higher than that for Australian exporters to New Zealand.

A significant proportion of tariff items have MFN rates of zero. For Australia, about 47 per cent of items have a rate of zero (table 2.1). In New Zealand, the proportion is substantially higher at 65 per cent.[2] About 53 per cent of the value of trans-Tasman trade in 2001 was duty free. Matching of the Australian and New Zealand tariff schedules indicates that

[2] See footnote b to table 2.1.

around 40 per cent of items are accorded an MFN rate of zero in both schedules. For these items, CER RoO are not relevant.

Figure 2.5 **Preferential margins within CER[a]**
Tariff items average, per cent




**a** The average rates exclude the duty paid on excisable tariff items, including alcohol, tobacco and cigarettes, and some petroleum-related products detailed in chapters 22, 24 and 27, respectively, in the trade classification. Before calculation of the margin of preference, duty collected on these items was set at zero. There was a tariff policy change in 1998 in New Zealand. For example, the 25 per cent ad valorem MFN tariff on imported motor vehicles was removed. It is therefore likely that the average fell significantly in 1999 and remained at the same level thereafter.

*Sources:* ABS (*International Trade, Australia*, Cat. no. 5465.0) and NZS (2003).

CER RoO are only relevant when the MFN rate is above zero in Australia *or* New Zealand. In 2001, this was the case for items covering about 47 per cent of the value of trans-Tasman trade. Looking behind this aggregate, about one-third of the value of Australia's exports to New Zealand and around two-thirds of New Zealand's exports to Australia had MFN rates above zero and were eligible for concessional treatment — ie duty free entry — under CER. For 44 per cent of tariff items,[3] the difference between the Australian and New

3 Estimated at the 6-digit tariff level.

Zealand rates was 5 percentage points or less in 2001. At such a level, the value of duty preferences is modest and the relevance of RoO limited.

Preferential trading arrangements favour the entry of goods into a PTA region through the low tariff country. The tariff relativities provide some incentives for some goods to enter the CER region through New Zealand. Without origin rules there could be an advantage in transhipment of some merchandise to Australia.

Any scope for transhipment in CER trade due to tariff differences, however, is eroded by trans-Tasman freight and other handling costs that add to the landed value of goods in Australia. Once these costs — estimated to be around 5 per cent, on average, of the 'value for duty' of trans-Tasman imports — are taken into account, the incentives for transhipment are likely to be minimal. They are likely to be of most interest for items which can be transported cheaply or for items where the MFN rates differ by more than 5 percentage points.

## MFN tariff differentials between Australia and New Zealand

The general analysis masks some large differences in MFN rates and hence in the preferences afforded by CER to individual industrial sectors. Figure 2.6, which shows average MFN rates by sector, highlights some of these differences.

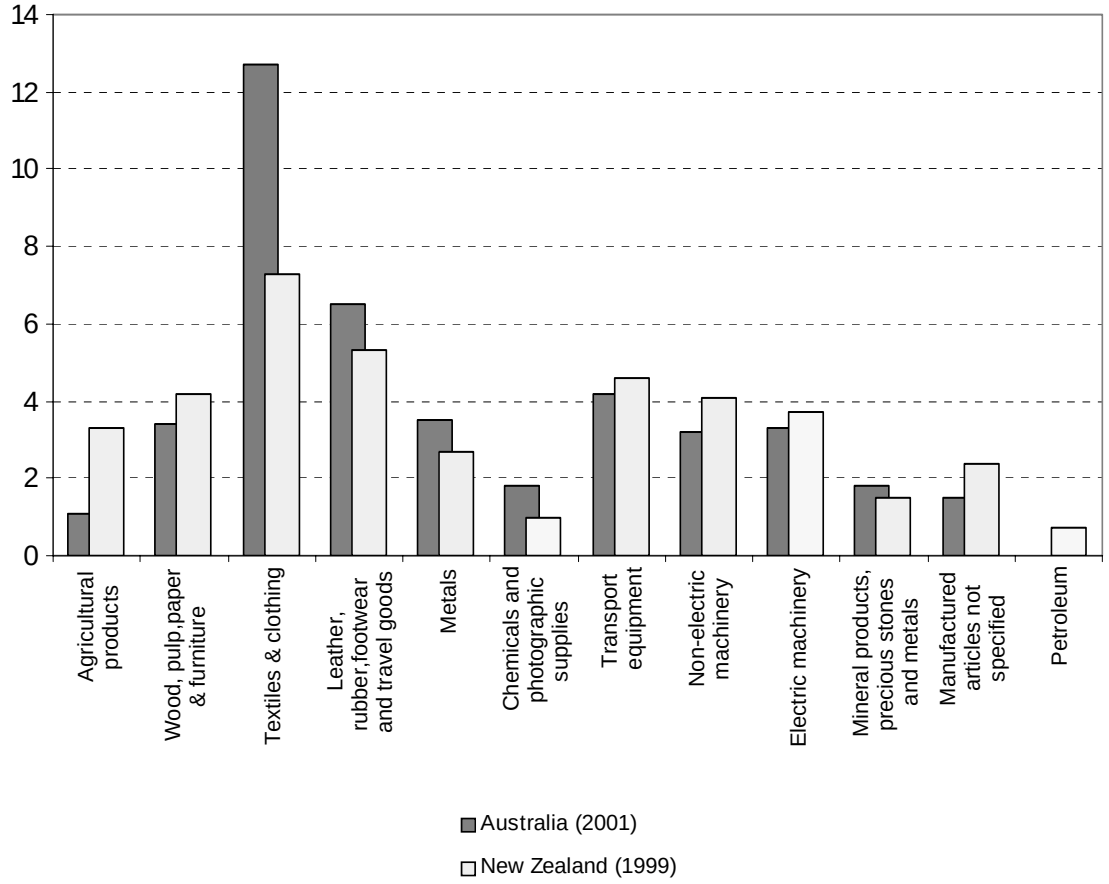
Average scheduled rates are higher in Australia than in New Zealand for a broad cross-section of activities, including: Textiles and clothing; Leather, rubber, footwear and travel goods; Metals; Chemicals etc; and Mineral products etc.

New Zealand scheduled duty rates are higher for Agricultural products; Wood and furniture; Transport equipment; Electric machinery; Non-electric machinery; Manufactured items not specified; and Petroleum.

Where the differences are significant — notably in Textiles and clothing; Leather, footwear and travel goods — CER tariff concessions are likely to be more important and the incentive for exporters to comply with the RoO in order to gain access to the preference is greater.

Figure 2.6 **Average MFN scheduled rates for Australia and New Zealand — industrial sectors**[a, b]

Per cent




**a** The WTO (2003c) calculated the average tariff rates using the WTO's Consolidated Tariff Schedules database (CTS) and the Integrated Data Base (IDB). The tariffs for agricultural products are the out-of-quota tariffs and non-*ad valorem* lines were excluded from the calculation of the averages. **b** Scheduled rates do not include the tariff concession orders.

*Source:* WTO (2003c).

## Duty paid on trans-Tasman trade

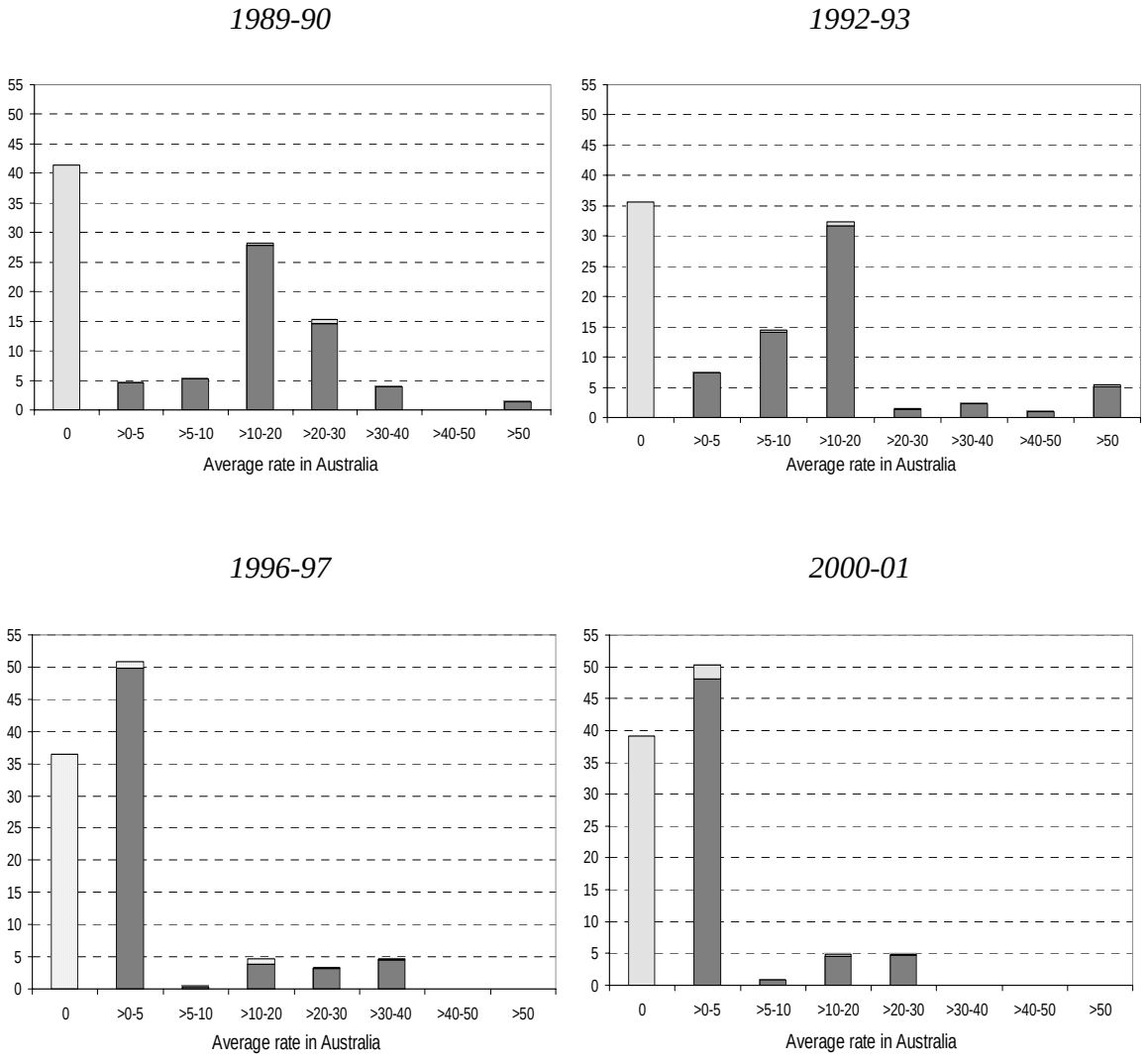
### *Imports to Australia from New Zealand*

Under CER, imports from New Zealand generally enter duty free (figure 2.7). Nevertheless, a small proportion of New Zealand goods enter at non-zero MFN rates. This proportion increased from 1 per cent in 1990 to 2.7 per cent in 2001.

New Zealand exporters that paid duty instead of using CER preferences in 2001 were concentrated mainly in the Harmonized System (HS) 2-digit categories of Chemicals

(HS 28 to 38), Plastics (HS 39), Machinery and mechanical appliances (HS 84) and Electric machinery and equipment (HS 85). The Australian *average* MFN rates for these items were 5 per cent. Duty was also paid on a small proportion of exports of Textiles, clothing and footwear (HS 59 to 65) and Vehicles and parts (HS 87).

Figure 2.7 **Imports to Australia from New Zealand by Australian MFN rate[a]**
Value share, per cent




**a** The average rates provided in the figure exclude the duty paid on excisable tariff items.

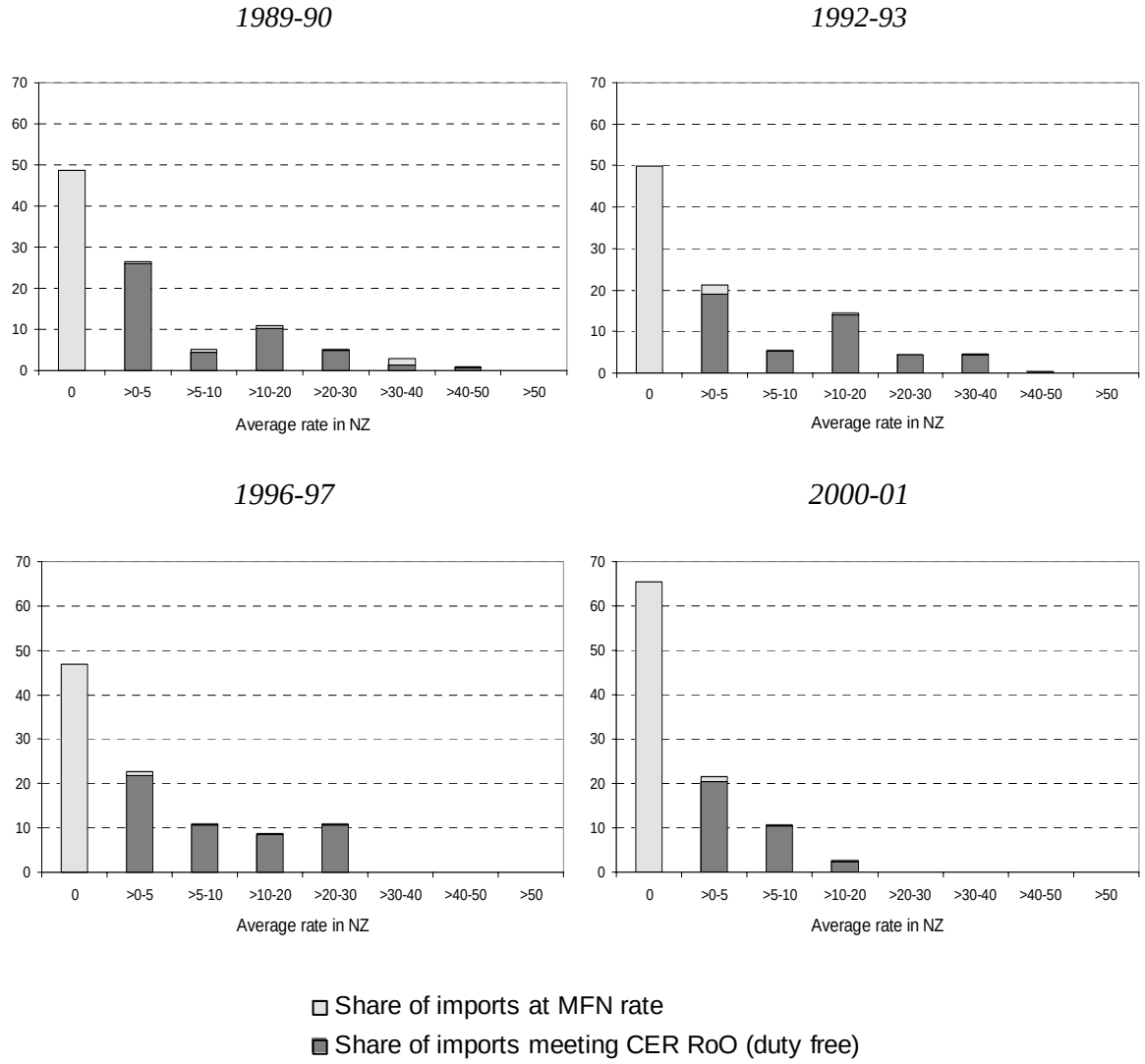
*Sources:* ABS (*International Trade, Australia*, Cat. no. 5465.0) and Australian Customs Service (2003d).

*Imports to New Zealand from Australia*

Most imports to New Zealand from Australia also enter duty free (figure 2.8), although a small proportion enter at non-zero rates. This proportion remained constant between 1990 and 2001 at around 2 per cent of imports.

Figure 2.8 **Imports to New Zealand from Australia by New Zealand MFN rate[a, b]**

Value share, per cent




**a** The average rates provided in the figure exclude the duty paid on excisable tariff items. **b** See footnote b of table 2.1.

*Source:* NZS (2003).

Australian exports that paid duty instead of using CER preferences in 2001 included HS 2-digit categories of Chemicals (HS 28 to 38), Plastics (HS 39), Paper and paper boards (HS 48), Fabrics (HS 58), Ceramic products (HS 69), Glass and glassware (HS 70), Metals

— iron and steel, copper, aluminium — (HS 72 to 76) and Electric machinery and equipment (HS 85). The average MFN rates for these items were 5 per cent in New Zealand.

FINDING

*Most trans-Tasman trade is duty free. More than half enters at a most favoured nation (MFN) rate of zero. Most of the remainder enters duty free because the goods satisfy the CER RoO.*

FINDING

*Tariff schedules in Australia and New Zealand are closely aligned. Scheduled tariff reductions will increase the alignment. By 2010, all tariffs in Australia and New Zealand will be 10 per cent or less and scheduled rates on individual items will be within 5 percentage points of each other. The relevance of CER RoO is minimal and declining.*

## The future tariff environment

Current debates about the CER RoO are taking place against a backdrop of declining tariffs in both countries and the intention of each country that this will continue (table 2.2).

In Australia's case, tariff levels have been reduced significantly, particularly since 1988. The general tariff rate for most items was reduced to 5 per cent or less on 1 July 1996. More than 47 per cent of tariff items now have a MFN rate of zero and a further 42 per cent have rates of 5 per cent or less. In the two sectors for which tariffs exceed 5 per cent — TCF and PMV — Australia is committed to further tariff reductions from 2005. In particular:

- tariffs in the PMV sector are scheduled to fall from 15 per cent to 10 per cent in 2005 and to 5 per cent in 2010; and
- the highest TCF tariffs — for apparel and some finished textiles — will be reduced to 17.5 per cent in January 2005, to 10 per cent in 2010 and to 5 per cent in 2015. Tariffs on cotton sheeting, woven fabrics, carpets and footwear will be reduced to 10 per cent in January 2005 and to 5 per cent in 2010. For other TCF items, tariffs will fall to 7.5 per cent or 5 per cent in January 2005, and any still above 5 per cent after January 2005 will fall to that level in 2010.

New Zealand's tariff rates were reduced significantly during the 1980s and 1990s. While a tariff reduction program was put on hold in 2000, about 65 per cent of tariff items now have a MFN rate of zero and a further 28 per cent have rates of around 5 per cent or less.[4]

[4] See footnote b to table 2.1.

Current tariff levels will remain until 1 July 2006, when they will begin declining across the board. High tariff rates — those between 17 per cent and 19 per cent, which apply largely to clothing, footwear and carpets — will be reduced progressively to 10 per cent by July 2009. Tariffs on all other goods with a MFN rate above 5 per cent will be reduced to 5 per cent by July 2008.

By 2010, with phased reductions in scheduled MFN rates in both countries, virtually all tariff items will have a difference in MFN rates of *5 percentage points* or less. With some exceptions, these differences will be based on scheduled rates of *5 per cent* or less.

Despite the low and declining levels of MFN rates in Australia and New Zealand, tariffs are likely to remain significant in the short term for some items, particularly those related to activities on very tight margins that are dependent on tariff and other support to maintain domestic market share (for example, certain TCF goods and some chemicals).

Table 2.2 **Selected tariff reduction schedules, 2005 to 2010**[a]

Australia and New Zealand, per cent

| *Year* | *Current* | *2005* | *2006* | *2007* | *2008* | *2009* | *2010* |
|---|---|---|---|---|---|---|---|
| ***Australia*** | | | | | | | |
| Clothing and some finished textiles | 25 | 17.5 | 17.5 | 17.5 | 17.5 | 17.5 | 10[b] |
| Cotton sheeting, woven fabrics, carpets, footwear | 15 | 10 | 10 | 10 | 10 | 10 | 5 |
| Sleeping bags, table linen, footwear parts | 10 | 7.5 | 7.5 | 7.5 | 7.5 | 7.5 | 5 |
| Other (yarns, leather etc) | 5 | 5 | 5 | 5 | 5 | 5 | 5 |
| Passenger motor vehicles | 15 | 10 | 10 | 10 | 10 | 10 | 5 |
| ***New Zealand*** | | | | | | | |
| Clothing, footwear and carpets | 17 to 19 | 17 to 19 | 17 | 15 | 12.5 | 10 | [c] |
| All items with tariffs of 10 to 12.5% | 10 to 12.5 | 10 to 12.5 | 10 | 7.5 | 5 | 5 | [c] |
| All items with tariffs of 5 to 7.5% | 5 to 7.5 | 5 to 7.5 | 5 to 7.5 | 5 to 7.5 | 5 | 5 | [c] |

[a] Australian tariffs will change on 1 January. New Zealand tariffs will change on 1 July. All specific tariffs in the New Zealand tariff schedule (which apply mainly to clothing) will revert to the clothing ad valorem tariffs on 1 July 2005. [b] To be reduced to 5 per cent in 2015. [c] To be determined after a review in 2006.

*Source*: Macfarlane (2003) and Dalziel, Anderton and Sutton (2003).

## 2.4 Concluding comments

The global trading system has seen a very substantial increase in preferential trading arrangements over the past decade The increased fragmentation of global production complicates the determination of origin for preferential market access. The increased

number of PTAs with diverse RoO increases compliance and administrative costs and can also have a significant influence on trade patterns.

There has been a big increase in the share of global exports accounted for by members of PTAs. Only a small proportion of the increase, however, is attributable to intra-PTA trade. One possible reason could be the restrictiveness of origin rules in the agreements and the greater importance of broader economic factors in determining the level and growth of trade.

With the decline in general tariffs in Australia and New Zealand, the margin of benefit from CER preferences has declined and is now at low levels. Planned tariff reductions by both jurisdictions will reduce the margin of benefit further.

Moreover, as general tariff rates have declined, there has been a modest increase, albeit from a low base, in the incidence of trans-Tasman exporters either not qualifying for, or not seeking, preferential entry.

# 3 Rules of origin and their role in trade agreements

Rules of origin (RoO) are used to determine the country from which goods originate for a variety of purposes such as applying tariffs, quotas, anti-dumping and countervailing duties. They are also needed for country of origin labelling and compilation of international trade statistics.

RoO can be categorised as either preferential or non-preferential, according to their use. *Preferential RoO* are used to ensure that only the products of countries which are party to a preferential trade agreement (PTA) are granted concessional entry. *Non-preferential RoO* are used for all other purposes. (While RoO are also important for determining the country of origin of particular traded services, these matters are handled in other areas of agreements.[1])

To provide context for a discussion about the efficacy of RoO that apply under CER, this chapter gives an outline of the variety of approaches used to determine origin, some of the trade-offs which are faced when formulating them and international developments in the design and application of origin rules. It notes the use in many PTAs of different RoO for different sectors.

## 3.1 The need for RoO

Preferential trade agreements encompass so-called *free trade areas* and *customs unions* ('regional trade agreements' in WTO terminology).

- In a free trade area, imports from countries within the group enter on a concessional basis (generally duty free), but each member sets its own duty rates on imports from non-members. The CER agreement created a free trade area comprising Australia and New Zealand.

[1] Free or concessional trade in goods has been the focus of most preferential trade agreements concluded to date.

- In a customs union (and more integrated arrangements such as common markets and economic unions[2]), all members impose the *same* set of customs duty rates on imports from non-members. The European Union (EU) is a major example.

In the case of free trade areas, RoO are needed to prevent 'trade deflection'. This occurs when, in order to minimise customs duties, imports from a non-member country destined for one member of the trade agreement are first shipped to the member country with the lowest tariffs and then transhipped to their intended destination within the free trade area. Without RoO, a free trade area could be very liberal, as the lowest tariff would apply to each imported good, irrespective of its source (Krishna 2002, p. 2).[3]

In the case of customs unions, where the treatment of goods imported from third countries has been harmonised, the common external tariff means that there is no advantage from transhipment and, in principle, no need for RoO:

> The great advantage of a [customs union] is that, because members have a common external tariff, it is possible to have much simpler internal border formalities — and possibly none at all. (World Bank 2000, p. 75)[4]

Indeed, to avoid trade deflection and complex RoO which impede trade, Krueger argued that regional trade agreements should be restricted to customs unions:

> … there is an important protectionist bias inherent in [free trade agreements] which is not present in [customs unions]. (Krueger 1999b, p. 91)[5]

However, most PTAs are not customs unions.[6]

Thus, the primary role of preferential RoO is to discriminate between goods that will receive concessional treatment and goods that will not. Indeed, origin matters only if it results in differential treatment:

---

2 Common markets may eliminate barriers to labour and capital flows across national borders within the market, while the term 'economic union' is used when members further merge their economies by, for example, establishing a common currency.

3 This assumes that any additional transportation costs do not outweigh the savings from lower import duties.

4 Nevertheless, Estevadeordal and Suominen (2003) noted that 'in practice, [RoO] are widely used in [customs unions], as well, either as a transitory tool in the process of moving toward the [common external tariff], such as in Mercosur, or as a more permanent means of covering product categories where reaching agreement on a [common external tariff] is difficult, for instance due to large tariff differentials between the member countries' (p. 2).

5 See also Krishna (2002, pp. 1–2).

6 Of the 162 RTAs notified to the GATT/WTO by August 1998, 19 were customs unions and 143 were free trade agreements. In the WTO's survey of 93 regional trade agreements operating in March 2001, six were customs unions and 87 were free trade agreements and other preferential regional trade agreements (WTO 2002, p. 8).

> In a world of no tariffs and no quotas — in a world of free trade — origin, apart from consumer preferences, would not matter. But in a world far from free trade, rules of origin are used to enforce and enhance discriminatory regimes. (Palmeter 1993, p. 338)

FINDING

*RoO are not needed where trade is free or where it is conducted on a non-discriminatory MFN basis.*

As a result of the proliferation in the number of agreements — and because there can be large differences between preferential and MFN tariff rates — the process of formulating RoO has become:

> … one of the most important and complex areas of preferential market access negotiations. (Estevadeordal 1999, p. 7)[7]

## 3.2 Assessing origin is difficult

Where goods are 'wholly obtained or produced' in a country, determination of origin is generally straightforward. However, this category is increasingly confined to some agricultural and mining products.[8] Production processes for many goods are now typically fragmented and use inputs sourced from several countries. Moreover, the nature and potential sources of inputs are continually changing, as is the technology and organisation of production itself. Consequently, attribution of origin to a single country can be problematic. In these circumstances, governments are forced to rely on negotiated and necessarily imperfect RoO that attempt to reconcile the goals of the PTA. In practice:

> … the origin of a product depends on the formulation and application of the applicable rules of origin. (LaNasa 1995, p. 2)

To provide guidance, the Kyoto Convention[9] of 1973 laid down the general principle that the origin of goods should be determined by the last or final country where the good was 'substantially transformed'.[10] In the view of LaNasa, this:

> … captures the heart of the meaning of the rules of origin in a simple, concise way. For a product to be from a particular state, it must be substantially transformed there. (1995, p. 6)

7 For a recent survey of the variety of RoO regimes, see WTO (2002).

8 OECD (2002, p. 140).

9 The International Convention on the Simplification and Harmonization of Customs Procedures (see United Nations Economic Commission for Europe 2003).

10 The Convention did not distinguish between preferential and non-preferential RoO. The WTO noted that 'sufficient working or processing' is a comparable concept in the context of preferential RoO (WTO 2002, p. 4).

The Kyoto Convention did not, however, provide operational rules for determining transformation and was non-binding (Lloyd 2002, p. 174). Countries are free to choose which approach, or combination of approaches, they adopt to determine the origin of their traded goods. On preferential trade, the Convention merely recommended that methods for determining origin be selected which:

> … can be most easily applied and controlled, with least risk of misunderstanding and fraud and the least interference with commercial activities. (WCO 1975)

Thus, it has been left to the parties to PTAs to agree to RoO that best satisfy their particular requirements at the time of negotiating the agreements.

## Different tests for origin are used

Following Kyoto, origin is typically assessed by the use of one or more of three general tests. A trade agreement may specify one of the following as sufficient to test for origin, or it may require a combination of these tests to be met:

- *the change in tariff classification (CTC) test* — a good is transformed if there is a change in tariff classification, using the Harmonized Commodity Description and Coding System;
- *the specified process test*[11] — a good is transformed if it has undergone specified manufacturing or processing operations which confer, or do not confer, origin of the country in which they were carried out. This test is sometimes used in respect of chemical products, for example; and
- *the regional value content (RVC) test* — a good is transformed if a threshold percentage value of locally or regionally produced inputs is reached in the exporting country.[12]

A review by the WTO of 93 agreements in operation in March 2001 found that only a few use RoO based on a single criterion. Most use at least two methods. In the WTO's assessment, adoption of multiple methods appeared to be a pragmatic response to the shortcomings of each particular method (2002, pp. 2, 7). Agreements entered into by the United States and the European Union use a CTC test as the principal means to determine origin, with additional technical test, RVC or other requirements for many tariff items.

11 This is sometimes referred to as the 'technical test'.

12 In the literature (including in the Kyoto Convention), the term 'value added' is sometimes used to describe this test. However, in practice, it is commonly specified as a required percentage of local or imported inputs, and not as a percentage of value added as that term is more commonly understood. (Under CER, for example, the rule is based on of the proportion of 'defined factory cost' which comprises 'defined qualifying expenditure'. It is nevertheless commonly referred to as a 'value added' test.)

Moreover, in some PTAs, a choice of origin test is offered for some tariff items. In NAFTA and more recent agreements based on that approach (such as the Singapore–United States FTA), one test is commonly based on a CTC rule alone, while a second test, for the same tariff items, may involve a CTC rule at a lower level, together with a technical test and/or RVC requirement. For such reasons, the incidence of an RVC test in CTC-based agreements can be considerable. In NAFTA, about 34 per cent of all tariff line items at the 6-digit level specify a RVC requirement as part of the first or second test. This means that about 70 per cent of items with non-zero rates in the United States tariff contain some form of RVC rule.

To date, the CER and other agreements involving Australia have involved a two-tiered test to determine origin. The test involves establishing that a good underwent a local manufacturing process and meets a regional value content threshold (chapter 1). The same test is used across all sectors and does not discriminate between activities.[13]

Overall, a survey of agreements by the WTO found that:

- the CTC method (generally operating at the 4-digit level) was the most common, being used in 89 agreements (table 3.1);
- the specified process test was used as a general method in a majority of the agreements surveyed (74 out of 93),[14] especially in the most recently concluded ones; and
- while the CTC and RVC methods are generally used across all chapters of the tariff, the specified process test applies more in relation to industrial products such as textiles and chemicals (WTO 2002, pp. 7–8).

FINDING

*PTAs typically use one or more of three general rules to determine the origin of goods. Implementation of each of these rules involves practical difficulties.*

[13] The legislative basis for determining origin in Australia is in Division 1A, Sections 153A to 153S of the *Customs Act 1901* and Regulations 107A and 107B.

[14] The specified process test is also used, as a secondary or exceptional rule, in 16 other RTAs.

Table 3.1 **Use of different criteria for determining origin**[a]

| | | *Method for determining origin* | | |
|---|---|---|---|---|
| | Number of agreements | *Change in tariff classification* | *Regional value content* | *Specified process or technical test* |
| Customs unions | 6 | 6 | 2 | - |
| FTAs and other preferential RTAs | 87 | 83 | 75 | 74 |
| **Total** | **93** | **89** | **77** | **74** |

**a** Results of a WTO survey of agreements in place in March 2001.

*Source*: WTO (2002, p. 8).

There can also be important differences in detail between agreements which are based around the same broad criteria. These include multiple formulations of tests, the specification of cumulation rules, absorption rules, de minimis or tolerance factors, differences in treatment of duty drawback and so on (box 3.1).[15] These are not trivial matters. Indeed, the WTO said that:

> In some cases these significantly modify what appears at first sight to be simple origin regimes. (2002, p. 2)

Additional complexity arises because countries may also use different primary methods for determining origin within different trade agreements to which they are a party. For instance, while Singapore's agreements with Australia and New Zealand use a regional value content rule, its agreements with the European Free Trade Association, with Japan and with the United States use the change in tariff classification method (supplemented with a regional value content rule for many tariff items). In each case, multiple rules usually apply. This is the reason for concern about the 'spaghetti' effects resulting from multiple RoO in multiple agreements with multiple countries (chapter 4).

15 Duty drawback allows tariffs on imported inputs to be either waived or reimbursed where the final product is exported. Some PTAs have a no-drawback rule, which can affect decisions on sourcing of inputs (Brenton 2003, p. 6).

Box 3.1 **Some additional features common to preferential RoO**

*Cumulation (or accumulation) provisions*

Cumulation allows producers to count materials purchased from outside the area as originating in the area for the purpose of determining the origin of the traded good. Consequently, for a product to obtain originating status, the degree of processing required to take place in the exporting member country will vary according to whether or not imported materials have been supplied by countries benefiting from the cumulation provisions (WTO 2002, p. 6).

For example, the Singapore–Australia FTA allows content to be calculated on the basis of accumulation. It takes into account all stages of the manufacturing process, even when interrupted by offshore processing, provided that the control of the material does not change before and after offshore processing. (Exclusions to this rule include textiles, clothing and footwear, passenger motor vehicle items and jewellery.)

Cumulation can take the form of:

- *bilateral cumulation* — (the most common form) whereby materials produced by any member country of the PTA can be counted as domestic content by the exporting country in its exports to other member countries;
- *diagonal cumulation* — whereby materials from specific non-member countries can be counted as domestic content by the exporting country; and
- *full cumulation* — whereby any processing in any member country can be counted as qualifying content regardless of whether the processing is sufficient to confer originating status to the materials involved. Put another way, the whole preferential area created by an PTA will be considered a single territory and *any* working or processing within the area will count towards the determination of origin.

*The absorption principle*

This provides that parts or materials that have acquired originating status by satisfying the RoOs for that product can be treated as being of domestic origin in any further processing and transformation. Consequently, any non-originating materials are no longer treated as such when assessing any further operations.

*De minimis (or tolerance) rules*

These allow a percentage of non-originating materials to be used without disqualifying the final product from preferential access. For example, under the Canada–Chile agreement, a tolerance of 9 per cent is permitted, while for several European Union agreements the tolerance is 10 per cent. However, exceptions are common. For example, under NAFTA there is a general 7 per cent tolerance, but with exceptions for sectors such as textiles and clothing, where no tolerance is permitted. (Under CER a tolerance of up to 2 per cent can be applied, but this is available only in particular, short-term circumstances and does not act as a de facto lowering of the threshold — see chapter 8).

(Continued next page)

Box 3.1 **(continued)**

For example, under the recent Singapore–United States PTA, a good that does not undergo the required change in tariff classification (Annex 3A) is nonetheless an originating good if:

a) the value of all non-originating materials used in the production of the good that do not undergo the required change in tariff classification does not exceed 10 per cent of the adjusted value of the good; and

b) the good meets all other applicable criteria set forth in this Chapter for qualifying as an originating good.

The value of such non-originating materials shall, however, be included in the value of non-originating materials for any applicable regional value content requirement of the good (Article 3.3(1)).

That agreement also provides a de minimis rule to complement the technical test (yarn forward rule) used for textile and apparel goods:

A textile or apparel good provided in Chapters 50 through 63 of the Harmonized System that is not an originating good, because certain fibres or yarns used in the production of the component of the good that determines the tariff classification of the good do not undergo an applicable change in tariff classification set out in Annex 3A, shall nonetheless be considered to be an originating good if the total weight of all such fibers or yarns in that component is more than seven per cent of the total weight of that component. (Article 3.3(2))

*Sources:* Brenton (2003, pp. 2–3) and WTO (2002, pp. 5–6, 9–13).

## 3.3 Special origin rules are common

Concerns that RoO can be used as an instrument of industry policy by governments and provide a focus for protectionist pressures from domestic producers are given credence by the special treatment accorded in some agreements to so-called ‘sensitive’ sectors. To the extent that this occurs, it can penalise industries that use products that are protected by the RoO and consumers can face higher prices than would otherwise be the case.

Two sectors that are most commonly afforded special treatment are textiles and clothing and the automotive sector. In many cases, they are subject to high MFN tariff rates, which increase the impact the RoO can have (chapter 4).

Typically, where RoO are restrictive, they are applied in a targeted and industry-specific way and are designed to be much more stringent than the RoO applied to other goods covered by the same agreement. In other words, restrictive RoO are usually intended to reinforce assistance to industries protected by relatively high tariffs.

Special treatment under RoO for such sectors might show up as differences in their treatment relative to other sectors in respect of:

- change of tariff classification rules that are different from those applying to other activities;
- sectors which are excluded from the agreement;
- extended time periods over which concessional rates of duty are implemented;
- varying levels of regional (or imported) content required;
- different permitted methods for measuring content;
- a specified process test, alone or in conjunction with other methods;
- additional quota restrictions; and/or
- different cumulation and tolerance rules.

Various combinations of these characteristics are widespread in trade agreements. Indeed, RoO are often subject to considerable 'fine print' — such as special rules for particular tariff items, differences in the application of tolerance or absorption rules and so on. For example, under the CTC method, goods produced from non-originating materials will generally acquire origin where there is a change in tariff classification. This, however, can be subject to qualifications or additional requirements in particular cases. For instance, under NAFTA, if imported goods are subsequently used in a motor vehicle engine assembly:

> … the value of the non-originating materials will be deducted when it comes to calculating the value-added of the engine as a whole. In the automotive sector regional value content requirements have been progressively raised from 60 to 62.5%, depending on the vehicle type. (OECD 2002, p. 143)

The additional requirements illustrate the important influence of domestic constituents on the formulation of rules (box 3.2). However, it is common for there to be a disparity between the interests of exporters of final goods, who want origin rules that allow them to use the lowest-cost components (regardless of source) and still obtain access to the markets of the preferential trade partner(s), and those of producers who look to origin rules as a form of restriction on potential competitors from within the PTA and wider afield.

In the case of the NAFTA rules for textiles, the OECD noted that the predetermined sequence of tariff changes required to achieve origin comes close to specifying the process for making the product. Moreover:

> … there is an incentive for producers to avoid any non-originating inputs, and this may result in trade diversion to the detriment of non participating countries. (2002, p. 142)

Box 3.2 **Meeting the needs of domestic constituents: NAFTA**

Mayer, in his study of the formulation of NAFTA, said that the three US carmakers had an interest in a fairly restrictive RoO to make it more difficult for European and Japanese competitors to locate assembly plants in Canada or Mexico and thereby ship finished automobiles to the United States duty free. However, apart from that, their interests differed somewhat:

> Because of [its] joint venture with Izuzu in Canada, [General Motors] favored a lower rule of origin, around 60 percent. For reasons that reflected their own patterns of production and competitive position, Ford and Chrysler preferred a higher rule, approximately 70 percent. [Domestic] Autoparts makers had every incentive to push for as high a percentage as possible, since high percentages protected them from foreign competitors. (1998, p. 158)

Mayer observed that, as in other parts of the NAFTA negotiations, this bargaining involved 'highly concentrated and powerful economic interests' and:

> … the negotiation begins to look less like a deal among three nations than a deal among a collection of private interests, many of whom span national borders. (1998, p. 162)

But he added that:

> … one cannot simply reduce the negotiation to these interests. National institutional structures matter in determining the rules of the domestic games, and hence the clout of the domestic players in determining national bargaining positions and international outcomes. (1998, p. 162)

Destler attributed the outcome for the automotive industry to the need for the US Government to garner sufficient political support to allow NAFTA to be concluded:

> … the automakers orientation remained central to US trade politics. A NAFTA that they opposed would not have been politically viable. (2003, p. 8)

*Sources:* Mayer (1998) and Destler (2003).

Most importantly, the OECD observed that the additional requirements may provide a *higher* level of protection from low-cost imports into NAFTA markets than existed before NAFTA (2002, p. 142).

This additional protection may limit the extent to which trade can be created between the PTA partners, increase the level of trade diversion and erode potential community-wide gains.

These trade-offs between the interests of individual firms which may benefit from additional protection and the interests of the community as a whole perhaps explain why, in practice, RoO may take longer than other parameters of an agreement to be settled. Indeed, RoO for cars, clothing and textiles were the last items for which agreement was reached in the NAFTA negotiations. Krishna and Krueger observed that the intensity of pressure from US industry:

> … certainly gave the appearance that the affected industries, especially automobile producers, viewed higher ROOs as in their self interest. That ROOs are regarded as important was reflected not only in industry pressure for them, but in the fact that ROOs occupy 200 pages of the NAFTA agreement. (1995a, p. 4)

The number of pages by itself does not necessarily mean that the RoO are complex. After all, a firm buying or selling auto parts under NAFTA needs only to refer to the rule affecting auto parts. The real point is that a detailed line-by-line formulation full of exceptions and special rules is suggestive of the protective nature of the approach to rules design. It can also hide favoured treatment for certain sectors and the extent of 'protection' available to local producers. It is the special rules and exceptions, not the underlying approach, that make for length, complexity and protective effects. As Krishna concluded:

> The precise form of the ROO matters. Lawyers and trade negotiators have clearly understood this for a long time. This is evident in the importance placed on the details of the ROO negotiated. (2002, p. 6)[16]

## Textiles and clothing are commonly accorded special treatment

In many agreements, textiles and clothing are treated very differently from other products, in part because their producers are significant employers of low-skilled workers in more developed economies (which generally have the stronger bargaining position). Production of textiles and clothing is also seen as an important agent of development and trade in developing countries, which have relatively low labour costs and therefore a significant advantage in (unrestricted) trade.

Reflecting this, many developed economies continue to impose tariffs on these products that are high relative to those on other goods, and importers commonly need to meet special rules before concessional entry is permitted under trade agreements. These rules vary in restrictiveness. Well-known examples are the special RoO regimes for textiles and clothing under NAFTA and subsequent PTAs entered into by the United States (box 3.3). These impose some very complex and restrictive rules for textiles and apparel, more so than for other products, and make third country inputs very difficult. The RoO can act as local content rules requiring virtually 100 per cent use of key material inputs from within the NAFTA region to qualify for concessional entry.

In contrast, there are no TCF-specific rules under CER. However, the problematic nature of trade in textiles and clothing is illustrated by the special regime put in place for the conduct of Customs inquiries into the entitlement of textiles, clothing and footwear to duty

[16] He noted, for example, the importance that Honda placed on the treatment of interest costs when content requirements were being defined for the Canada–United States FTA (2002, pp. 6–7).

free treatment under CER (chapter 6) and by the interest shown in this study by the TCF sector in both Australia and New Zealand.

Box 3.3 **The 'yarn forward' rule**

The basic origin rule for textile and clothing articles under NAFTA and like agreements is the 'yarn forward' rule, which in many cases requires that the yarn used to form the fabric (which might subsequently be used to produce clothing or other textile articles) must be formed (that is, spun, or in the case of filament yarn, extruded) within the territory of the trade agreement.

Variations of this rule are also used in more recent US trade agreements, such as those with Chile and Singapore, and that being finalised with Australia. RoO for clothing under some EU agreements are similarly restrictive (Brenton 2003).

Discussions leading up to the Singapore–United States FTA highlighted the divergence of opinion held by US textiles and clothing industry interests. While clothing importers argued for an agreement free of restrictive RoO, the American Textile Manufacturers Institute advocated that the NAFTA 'yarn forward' rule be used in all US free trade agreements, including with Australia (ATMI 2003, p. 2). An advisory committee to the US Trade Representative said that:

> … the fiber, yarn and textile members largely support the requirements of a yarn forward rule that grants benefits only to the signatories of the agreement … In contrast, apparel members … argue that the rule of origin discourages apparel trade among the beneficiary countries, which will in turn diminish sales opportunities for fabric and trim suppliers. (ISAC 2003, p. 2)

Indeed, the US apparel interests noted that the Singapore–United States FTA, which in the event adopted a yarn forward model:

> … will have no significant effect on apparel or textile trade between the signatories because the US apparel industry will find little or no benefit to using the FTA. [Its RoO] are still too restrictive to serve as the foundation for any trade creation. (ISAC 2003, pp. 5–6)

*Sources:* Brenton (2003); ATMI (2003) and ISAC (2003).

## Sector-specific rules can reduce the benefits from a PTA

Special rules of origin within PTAs are not confined to the textiles and clothing industries. Other industries where special arrangements commonly apply include the automotive industry, agriculture (sometimes handled by way of complete exclusion) and some electronics industries. Again, these are not issues for the current CER, which has no industry-specific RoO.

Because it is not widely understood how different sets of RoO can have different effects — and because the process of negotiating them is not transparent — they can become a focus for lobbying and rent-seeking by those with direct economic interests at stake. Indeed:

> … agents who stand to lose from an FTA can undo its effects without, for the most part, even being seen as doing so. (Krishna 2002, p. 6)

Cutbush argued similarly that RoO can be viewed as forms of 'administered assistance' which:

> … in purely administrative guise, actually deliver assistance selectively to industries, quietly and without any national interest test … little is likely to be understood about them. Thus they become non-transparent devices, making them ideal targets of influence and attractive mechanisms for delivering advantage. (sub. 45, p. 2)

If RoO are used as a protective device, they can counteract the broader intent of the agreement to liberalise trade between the participating countries. In this context, commentators focusing on the potential community-wide benefits of trade agreements have for some time expressed serious concerns about the sectional and protectionist aspects of the RoO used in agreements such as NAFTA.

FINDING

*RoO for industries such as textiles, clothing and footwear and motor vehicles are often complex and restrict trade in these products. In doing so, they can preclude benefits that would otherwise be available to producers of finished products and to consumers.*

## 3.4 The WTO's efforts to harmonise RoO

In the 1980s, it became increasingly clear that harmonisation of RoO — the establishment of one set of rules to be applied by all countries for all purposes — would greatly reduce uncertainties facing the trading community and the possibility of RoO being misused as an instrument of restrictive commercial policy.

In the late 1980s, an increased number of origin disputes (including in relation to anti-dumping) led to inclusion of this issue in the Uruguay Round. During that Round, the *Agreement on Rules of Origin* was signed. It agreed to harmonise *non-preferential* RoO and ensure that they are applied equally for all purposes. The Agreement aims to make RoO objective, understandable and predictable, and to ensure that they do not create unnecessary obstacles to trade.

That work was not completed during the Uruguay Round and is continuing within the World Customs Organization and the WTO. However, while some progress has been achieved, the timetable has been extended, most recently until July 2004. The work program is based on a number of general principles, including that origin should be conferred on 'the country where the last substantial transformation has been carried out' (DFAT, sub. 10, p. 4). DFAT said that, while agreement has been reached on a large number of issues:

> … overall agreement has been delayed pending agreement on 94 outstanding 'core policy issues' and debate over the scope of application of the harmonised rules. (sub. 10, p. 4)

Until the completion of the harmonisation program, contracting parties to a trade agreement are expected to ensure that their RoO:

- are transparent;
- do not have restricting, distorting or disruptive effects on international trade;
- are administered in a consistent, uniform, impartial and reasonable manner; and
- are based on a positive standard (in other words, they should state what does confer origin rather than what does not) (WTO 2003d).

For the longer term, the Agreement aims for a single set of RoO to be applied under non-preferential trading conditions by all WTO members in all circumstances. However, it does not cover *preferential* RoO. As the OECD noted:

> It is difficult to draw firm comparisons between current WTO provisions on [non-preferential] rules of origin … and corresponding provisions in [PTAs], because of the very different nature of the two types of provisions. [PTAs] contain detailed rules of origin, while WTO provisions mainly introduce general principles '*to govern the application of rules of origin*' and not detailed rules of origin as such. (OECD 2002, p. 135)

While a 'Common Declaration' annexed to the Agreement stipulates that the general principles and requirements contained in the Agreement should apply also to preferential RoO, the current harmonisation program applies only to non-preferential RoO. In practice, little progress has been made toward harmonising preferential RoO.

FINDING

*International efforts to harmonise RoO have concentrated on non-preferential rules. Little progress has been made on the harmonisation of preferential RoO.*

## 3.5 Concluding comments

RoO are only required because PTAs typically involve departures from the central norm of non-discrimination in GATT. In seeking to confine access to tariff preferences to PTA members, RoO invariably place some restrictions on trade. But while the GATT has increasingly restricted the ability of countries to use tariffs or traditional non-tariff barriers to protect domestic industry from foreign competition, it does not regulate RoO.

Three basic methods of determining origin, which appear relatively straightforward, are used. None of these is fully satisfactory. The methods are sometimes used in combination and are often supplemented by secondary criteria.

Consequently, in practice, much comes down to the process of negotiating a trade agreement, and the pressures on negotiating teams from various interests in their home countries. An important consequence is that, for the same good:

> … it is clear that different rules of origin can lead to different determinations of origin. (Brenton 2003, p. 2)

RoO can provide an opportunity for countries to satisfy pressures from some domestic interests for protection from foreign competition. Industry-specific RoO typically reinforce assistance to industries with relatively high protection. They can reduce the benefits that might otherwise flow from a PTA.

While multilateral trade reform usually simplifies trade rules and thus reduces administrative costs and sectional advantage, RoO represent a step in the opposite direction. Indeed, they can effectively insulate an industry from the competitive consequences of a PTA.

The advantages and disadvantages of each method or combination of methods and the various ways they are implemented, and possible changes to CER rules, are discussed later in this report.

# 4 Economic effects of rules of origin

Countries that negotiate PTAs expect to benefit from improved opportunities to import and export. Depending on the provisions of the PTA and the nature of the markets involved, benefits can include lower prices for goods and services and a wider range of products in home markets, and larger export markets.

RoO are a necessary part of a PTA. They are designed to enforce the discriminatory nature of a trade agreement, but can impose economic costs of their own. Depending upon how they are specified, they can — to varying degrees — restrict trade, misdirect investment, inhibit productivity growth and reduce welfare in the same manner as a traditional barrier to trade.[1] They can also raise the administrative costs to firms of doing business (including complying with paperwork requirements) and the Customs Services face costs in administering and auditing the RoO.[2] These costs are not trivial (see chapter 6).

If RoO were to make no major changes to the purchasing, production and trade incentives facing firms, their effects would be largely benign. For example, where trade involves goods which are accorded duty free status on a MFN basis by all members of the PTA (and are not subject to non-tariff barriers), preferential RoO are not an issue.

Where one or more members of a PTA apply tariffs to restrict imports from non-member countries, however, RoO can 'bite'. In these circumstances, firms have the choice of purchasing from non-PTA sources — where the price is inflated by a tariff — or on a duty free (or concessional) basis from sources within the PTA area.

Under CER, the 'margin of preference' between the tariff treatment of goods that meet the RoO and can enter duty free from the PTA partner country and those that are imported at the MFN rate can be up to 25 percentage points (in the case of apparel and some finished textiles).[3]

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1 There is a small but expanding literature on this subject — see, for example, Krueger (1993), Krishna and Krueger (1995b), Vermulst et al. (1994), Hoekman (1993), Estevadeordal (1999) and Brenton (2003).

2 As Krueger (1993, p. 16) observed, 'Even when ROOs are not highly protectionist in intent, they increase producers' costs and require administrative surveillance'.

3 The OECD (2002, p. 3) noted that preferential RoO are usually more stringent in their application than MFN rules of origin, 'and the more so for products for which the margin of preference between the MFN and the preferential tariff is larger'.

That margin provides incentives for some producers to change their production decisions so as to meet the requirements of the RoO. This may involve decisions about where to purchase inputs, locate production, market their products and so on. As a consequence, their cost structure, productivity and competitiveness will be affected. Thus, RoO can have distorting effects on the economic behaviour of businesses in a manner similar to those of tariffs and taxes.

The extent of these effects will depend upon such factors as: the differences between the margins of preference available on inputs and on final goods; the degree to which domestic and foreign products are substitutable or complementary; the cost structure of industries producing inputs and final goods in each PTA member country; the elasticity of demand and supply for such goods'; any terms of trade effects and the degree of competition prevailing in the partner economies.[4] However, in broad terms, the welfare effects of RoO are determined by the relationship between their restrictiveness and the size of the margin of preference provided. The rest of this chapter examines these issues.

## 4.1 Trade and welfare effects

At the level of the firm, responses to the incentives provided by the RoO depend upon the nature of its activities and the markets in which it operates.

- For goods falling within many tariff items, RoO will have little or no effect on trade and welfare. This will obviously be the case, for example, where the MFN tariff is zero and there is consequently no preference. It will also be the case for trade in agricultural or other products which are clearly 'wholly produced' within a PTA member country (irrespective of whether the goods are subject to a MFN tariff). A more or less restrictive RoO should have no effect on trade in these goods because identifying PTA produce will be uncontroversial.
- For some firms, the margin of preference will be sufficient to induce them to accept a less favourable input mix and a higher cost structure in order to obtain preferential access for their exports of finished goods to other PTA countries.[5] For example, they may purchase higher-priced inputs from within the PTA area, rather than lower-priced and/or better quality inputs from an otherwise preferred source outside of the PTA.[6] They may also persist with less efficient technology or production arrangements.
- Other firms may forgo preferential treatment for their final goods in the PTA market by continuing to obtain inputs from preferred (perhaps highly competitive) suppliers

4 On this last point, see Krishna and Krueger (1995b).

5 See Stephenson (1997, p. 17).

6 In this way, RoO act simultaneously as a tax on the imported input and a subsidy on the domestically produced input (Lopez-de-Silanes et al. 1993).

outside of the PTA area. They may judge that the benefit of the margin of preference is insufficient to outweigh the compliance costs and efficiency losses involved in changing input sources. They will then attempt to compete in the PTA final goods market while subject to MFN rates on their output (possibly against some competitors who will trade duty free).

Some of these outcomes will be associated with higher costs of production, reduced competitiveness and less trade than would otherwise occur.

RoO affect the competitiveness of both producers of traded final goods and intermediate inputs used in their production. Member country input producers benefit from a RoO to the extent that firms are induced to purchase more inputs from PTA sources. In effect, the RoO will operate as a local content scheme, to the detriment of downstream or final goods producers and consumers.[7] In general, the more restrictive the RoO, the greater the scope for such input trade diversion to occur.[8] Duttagupta and Panagariya observed that:

> ... the yarn forward rule directing trade in textiles in the NAFTA (which virtually amounts to a 100% value-added RoO) has played a crucial role in the phenomenal expansion of the US–Mexican trade in textiles. (2001, p. 28)

The widely different impacts generated by RoO — whereby additional costs are imposed on some while others benefit — help to explain the various attitudes to alternative formulations of RoO. Producers of goods that compete with imports from a member country will lose competitiveness if RoO are relaxed. On the other hand, exporters within the PTA would generally prefer more liberal RoO to facilitate entry into the other PTA markets and to allow greater access to lower cost inputs. Producers of intermediate inputs (such as some textiles and basic chemical products) with little capacity or interest in exporting themselves would generally benefit from stricter RoO to encourage local demand for their products and minimise the extent of increased competition through preferential entry.

## The trade-offs introduced by RoO and their effects

The impact of RoO should be considered against the backdrop of the bilateral tariff reductions that are part of the PTA with which they are associated. Following establishment of a PTA, trade between member countries is likely to rise in response to the margin of tariff preference which the PTA has introduced. On the other hand, trade with non-PTA sources is likely to fall to the extent that imports from lower-cost, non-member sources are displaced by trade between member countries. Thus, some of the new trade

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[7] See Corden (1971); Grossman (1981); Mussa (1984) and Krishna and Krueger (1995b). RoO can cascade protection along the production chain (Hoekman and Leidy 1993).

[8] See, for example, WTO (1995, pp. 48–49).

will be ‘trade creation’ among member countries and some will be ‘trade diversion’ from non-member to member countries (box 4.1).

In general, if barriers to trade are reduced multilaterally, economic gains from trade result. But if barriers to trade are reduced selectively under a PTA — and are subject to the operation of RoO — the outcome is less clear and depends on a number of factors.

> This is true because discrimination between sources of supply is not eliminated, it is simply shifted. (World Bank 2000, p. 40)

In practice, it is difficult to find statistical evidence of net effects on the national welfare of countries that are members of a PTA. This is because the impacts tend to be focused on particular industries or products — the CER RoO, for example, appear to have most impact in only a few industries — and because so many other factors, such as general economic growth, changing economic conditions and the impacts of economic reform, play an important role.

The RoO, which have an impact additional to that of the bilateral tariff reductions under the PTA, play a central part in determining the net outcome. Where they are highly protective, they can erode potential gains from the PTA.

It has been suggested,[9] for example, that the ‘yarn forward’ or ‘fibre forward’ rules for textiles and clothing — used in some PTAs to which the United States is a party — effectively reserve the market for such goods to member countries only. In some circumstances, they can restrict trade among PTA members. For example, under the United States–Canada FTA, the RoO did not permit the production of aged cheese from fresh milk to confer origin, in effect preventing free trade in cheese *within* the FTA (Krishna 2002, pp. 6–7). The OECD also noted that, at the extreme, the removal of tariffs and non-tariff barriers by a PTA could be counteracted by the RoO to the point where the trade liberalisation provided for under the PTA would be nullified (2002, p. 3).

[9] See, for example, James (2003, p. 3); James and Umemoto (2000).

Box 4.1 **The welfare effects of tariff reductions in PTAs**

A PTA can have both positive and negative effects on the welfare of a member country.

The selective reductions in tariffs benefit the importing country. Where trade is created, consumers and producers can benefit from lower prices.

But the discriminatory nature of the reductions in tariffs can also divert, as well as create, trade.

Where trade is diverted away from a cheaper supply outside the PTA area, it increases the import price of goods in the importing country, perhaps to the levels supported by tariffs on non-PTA imports. The extent to which this occurs will depend upon the level of competition between suppliers in the PTA area and the degree to which PTA area demand is met from member countries. Trade diversion benefits the PTA member country that now supplies the market. It harms the non-member country outside the PTA which previously supplied the importing country.

The effects on the importing country may be positive or negative. The increased cost of imports is a loss, a negative terms of trade effect which the following example from the World Bank (2000, p. 40) illustrates.

> Suppose that an imported good from a partner country costs $105 per unit, $100 from the rest of the world (ROW), and that in both cases duty is $10, making the prices paid by consumers $115 and $110 respectively. In this situation, consumers obviously purchase from the ROW at $110. If the country joins a PTA with the partner, imports are duty-free, so the price consumers pay for imports from the partner country falls to $105, while imports from the ROW still cost $110. Consumer choices are obvious: they switch to the partner country, buying the $105 good and saving $5. But the government now loses $10 per unit (the revenue it was getting on each unit of imports from the ROW), so the net effect for the country is a loss of $5 — the PTA has reduced real income. This is the deleterious welfare effect of 'trade diversion'.

The fall in the domestic price of the goods is a gain to consumers and it leads to a production gain to the extent that domestic prices converge to world prices and the allocation of resources is improved. The net effect of trade diversion may be positive or negative.

*RoO have additional effects*

These results of trade diversion apply to the markets of final or more fully processed products. This might be called final goods diversion. To this must be added the effects on domestic producers of intermediate goods whose sales are affected by RoO.

RoO may result in trade diversion of intermediate goods by encouraging the exporter to substitute more expensive or lower quality intermediate inputs from within the region for cheaper or higher quality inputs available from outside the region in order to meet the RoO and qualify for preferential entry.

(Continued next page)

Box 4.1 **(continued)**

For the exporting country, the benefits of its new exports to the partner country are partially offset by the additional cost of buying more expensive or lower quality inputs from within the region. For the importing country, the new imports from the trading partners may be either trade creation or trade diversion. All that matters is the price of final or more fully processed products. As noted, this may lead to a net welfare gain or loss.

*Overall*

Thus, trade diversion lowers the benefit of increased trade to both importing and exporting members. There is a presumption that members will gain overall from new trade (especially if this new trade also results in lower unit costs due to economies of scale and productivity improvements or to increased competition).

The net benefits of a PTA are improved if RoO are less trade-restricting as this lowers input trade diversion, lowers consumer prices and improves the allocation of resources and national output.

The effects of RoO will be magnified where there are significant differences in the external tariff regimes of the PTA member countries. The larger the differences between their MFN rates (a broad indication of the relative competitiveness of their firms), the greater the incentive to buy higher-cost inputs from a PTA member country to satisfy the RoO and thereby obtain the duty concession on their final goods sold within the PTA.[10] The higher the MFN tariff on the final good, the more firms will be prepared to forgo in cost efficiencies in order to benefit from the concession on their final goods. The extent of any trade effects will be limited by the height of a country's MFN tariff— there can be no impact on trade if the MFN tariff is zero or if MFN rates are common between member countries (the customs union case).

Thus, two important forces are at work. On the one hand, the origin requirements can encourage firms to divert demand to higher-cost suppliers within the PTA region. This would *reinforce*, through regulation, the incentives for trade diversion inherent in the bilateral tariff reductions of a PTA and reduce welfare from what it would otherwise be. On the other hand, more restrictive RoO (and the high compliance costs which can accompany them) may induce some firms to eschew the preferential PTA arrangements and trade on an MFN tariff basis. This by itself will *nullify* some of the effects that would otherwise arise from trade diversion.

[10] The RoO will also have trade creation and trade diversion effects in the intermediate goods market. This can generate output effects in the intermediate goods market. Together with the consequent second-round effects which follow, this may, in particular circumstances, lead to further gains or losses in welfare.

For these reasons, the net impact of RoO comprises a complex mix of effects on trade, production and consumption. At the extreme, RoO may be so restrictive that they prevent any duty free trade between member countries in the goods concerned. In such cases, the potential gains are forgone. For example:

> It is consumers … who … ultimately pay for the induced inefficiencies brought about through restrictive origin requirements, through higher prices for final products and a loss of associated welfare. (Stephenson 1997, p. 17)

Moreover:

> The more integrated a country is in international trade, the more both its firms and consumers will suffer from being restricted in their choices by the rules of origin. (Stephenson 1997, p. 17)

Because of the complexity of some RoO regimes, it may be very difficult to analyse the effects on national welfare.[11] An empirical study by Estevadeordal (1999) supported the view that the NAFTA RoO were used as 'an independent commercial policy instrument with a 'primary' market access function'. He concluded that 'the same forces that push for tariff protection also push for more restrictive RoO' and that in PTA negotiations:

> … ROO and preferential tariffs are both primary policy instruments for market access negotiations. (p. 17)

At a broader level, as the WTO observed:

> Even as global tariffs are falling — thanks to successful rounds of multilateral liberalization — a maze of conflicting regional regulations, standards and rules of origin risk becoming the new 'walls' between [trading] blocks. (Moore 2000)

FINDING

*RoO enforce the discriminatory nature of a PTA. The economic impacts depend on how restrictive they are and the extent to which the external tariff regimes of the member countries differ. Highly restrictive RoO can erode the gains from lower tariffs in a PTA.*

## 4.2 Investment effects

Rules of origin can also induce changes in the location of production between member countries of a PTA. Some production may be relocated from outside to inside the PTA in response to a desire to meet origin requirements and make that production eligible for duty free access to the PTA markets. Equally, decisions about new investment will be

[11] Studies of the welfare effects of trade policies commonly use a comparative static framework. However, this can understate the gains from reducing trade restrictions because it ignores the dynamic benefits of freer trade, such as the availability of new goods and increased innovation (see, for example, Romer 1994 and Chand, McCalman and Gretton 1998).

influenced by the cost structure imposed by the RoO and MFN tariffs. It might, for example, be cheaper for a firm to locate production capacity in Asia for the Asian market if the cost of producing within the CER region for export to Asia is increased unduly by having to meet the RoO for trans-Tasman exports.

Either way, RoO can shift the margin of comparative advantage between countries and may encourage inefficient relocation of production ('investment diversion') among PTA member countries (Rodriguez 2001).

Where RoO effectively allow minimal or no third country inputs (as can be the case with respect to sensitive sectors such as motor vehicles and textiles and clothing), producers in member countries may have little choice but to establish domestically-focused (that is, import-competing) operations with the majority of their inputs obtained locally. In this way, they can preserve the preferential status of their finished products. However, this is not costless — it means that their output is less likely to be international competitive. In addition, having incurred adjustment costs to respond to the incentives created by concessional tariffs and RoO, additional rounds of adjustment would follow later tariff reductions undertaken as part of multilateral trade negotiations or national policy changes.

These trade-restricting effects of RoO on investment location decisions are akin to the incentives provided by high tariff walls. Both can result in companies choosing to establish production in protected import-competing activities rather than globally focused activities. (Again, both may imply future adjustment costs as future RoO or tariff regimes change.)

However, as with trade effects, the overall impact on welfare will depend upon the circumstances of the PTA and the nature of the RoO. For example, RoO may encourage new investment in higher or lower-cost areas in response to the selective reduction in tariffs caused by the PTA (box 4.2). Where the PTA increases efficiency and national income, new investment within the PTA area will be beneficial.

Referring to some of the impacts of NAFTA, Jensen-Moran (1996) argued that 'trade battles are becoming investment wars', with PTAs becoming 'vehicles of forced investment'.[12] Outsiders have:

> … a stark choice: invest in production facilities within the region, or don't trade with it at all. (p. 1)

She cautioned that while the resulting investment may provide higher-wage jobs and technology to a particular locality, it also distorts trade and investment patterns and undermines the longer-term competitiveness of the companies and the countries involved (1996, p. 1).

[12] Examples include motor vehicle investments in the United States and clothing production in Mexico.

Box 4.2 **RoO and investment effects**

The European Union's 1989 decision to require that the wafer fabrication stage of semiconductor production be performed in the European Union to avoid a 14 per cent tariff provides an illustration of how rules of origin within PTAs influence foreign direct investment (FDI) flows:

> The measure was a significant factor in the jump in FDI in European semiconductor fabrication facilities, which rose 20 per cent between 1987 and 1990, despite higher production costs relative to the United States or Asia. For example, Intel's decision to expand FDI in Europe was influenced by the need to meet this new standard. (Jensen-Moran 1996; UNCTAD 1999, p. 15)

UNCTAD also cited investment effects arising from NAFTA RoO in high technology products, which it said affected both existing and prospective investment decisions regarding production in Asia.

> ATT shifted production of telecommunications equipment from Asia to Mexico due to a requirement that at least nine of ten printed circuit boards (the key component of office switching equipment) be packaged within NAFTA to qualify for its trade benefits.
>
> Canon reportedly invested over $100 million in a new United States copier facility, rather than building the plant in (lower-cost) China or Malaysia, because a special NAFTA rule of origin for copying machines required the equivalent of 80 per cent local value added. (Jensen-Moran 1996; UNCTAD 1999, p. 15)

In the case of CER, some companies are increasingly faced with having to decide where to locate new investment, a task perhaps made more complicated in view of the increasing number of PTAs in which Australia and New Zealand are becoming involved. The Employers & Manufacturers Association (Northern) (EMA New Zealand) said that RoO would be one of several criteria underlying new investment and decisions on where manufacturing should occur for New Zealand-based companies looking to sell products into Australia.

> Appliance manufacturing would be a good example of this and has seen some movement already on investment into Australia. (sub. 3, p. 5)

## 4.3 The efficiency and productivity of firms

As noted earlier, some firms will be induced by the RoO to accept a less favourable input mix and a higher cost structure in order to obtain preferential access for their finished goods in other PTA countries. These impacts may occur across the board, or be focused on particular industries or firms, depending on how the RoO are formulated.

Some firms may also find that their efforts to lower costs and increase productivity through technical innovation and improved business practices can disadvantage them in meeting the requirements of the RoO. This has been a concern for some time for CER RoO. For

example, Stephenson, in 1997, noted that the then New Zealand motor vehicle manufacturers[13] were concerned that, as they increased productivity, they might no longer meet the 50 per cent local content threshold. They could also be penalised in some instances where they purchased inputs more cheaply from preferred sources worldwide. Thus, their efforts to lift productivity risked placing them at a disadvantage in meeting a fixed percentage of local content. Stephenson observed that:

> Continuing to benefit from preferential tariff treatment would require these firms to retain less efficient production patterns. (1997, p. 21)

More recently, some New Zealand participants said that the 50 per cent threshold was much easier to achieve with older, more labour-intensive (but less efficient) production processes, whereas newer and more technically advanced processes, using reduced labour inputs, faced more difficulty in achieving 'originating' status. In such situations, the local content threshold may induce some firms to persist longer with factories or assembly lines which are sub-optimal in terms of technology in order to meet the origin rules.

In addition, as producers become more successful at exporting and their production runs increase, the share of overheads that they can attribute to a particular market will decline (chapter 5). Under a RVC rule, such as CER, this alone will reduce (measured) local content and a producer's capacity to meet the origin rule.

More broadly, the current CER RoO can provide an additional source of commercial uncertainty for some producers, whose capacity to set future prices for sales of their final goods (and to contract to buy inputs on a forward basis) is impeded because they find it difficult to forecast with sufficient accuracy whether a particular product will gain preferential treatment (chapter 5). This is a significant day-to-day issue for some producers, for whom forward exchange rate cover is only a partial solution.

The 'bookkeeping' requirements of CER RoO also hamper the efficiency of exporters that sell into multiple markets. More specifically, it means that production of the same goods needs to be segmented and accounted for separately, depending on whether they are intended for a PTA or non-PTA export market. Such outcomes increase transaction costs and further reduce business productivity. As Garnaut noted:

> … rules of origin increase transaction costs and reduce business productivity. … that goes in exactly the opposite direction to the developments associated with Australia's movement towards free trade in the past 20 years. (2003a, p. 199)

[13] New Zealand no longer manufactures motor vehicles.

## 4.4 Empirical work on RoO

Until relatively recently, little empirical work had been undertaken to quantify and analyse the impacts of preferential RoO in PTAs. However, studies in the past few years have developed alternative ways to examine the effects of RoO on trade and investment. Some have been referred to in the foregoing text. A selection of other findings is summarised in box 4.3. In the main, they focus on origin rules in NAFTA and PTAs involving the European Union. While the evidence is still patchy, these studies suggest that:

- RoO have had a major independent impact on trade and market access;
- high margins of preference are associated with more trade-restrictive RoO;
- trade-restrictive RoO can reduce the utilisation of available preferences under PTAs;
- trade-restrictive RoO encourage use of intra-PTA inputs;
- RoO have diverted resources from their most efficient uses; and
- RoO can hamper PTA-induced trade liberalisation significantly.

### The restrictiveness of RoO regimes

The Commission has estimated the relative trade restrictiveness of various PTAs using an index framework. This is a useful way to assess the degree of restrictiveness of various provisions when price and quantity measures are not readily available. It quantifies prevailing restrictions into a summary measure to facilitate comparisons on a common basis across PTAs. The index measures provide insights into the extent to which RoO-related regulatory barriers may restrict trade.

Box 4.3 **Some empirical evidence on the effects of RoO**

Some themes in the literature are as follows:

*RoO have an impact on trade*

- RoO can raise barriers to trade among PTA member countries as well as between members and non-member countries (Shibata 1967, Krishna and Krueger 1995b and Stephenson 1997). Complex rules can undo the liberal effect of the preferences provided.
- Cadot et al. (2002) found that the negative effects of RoO and other administrative compliance costs largely offset the positive effects of tariff preferences in NAFTA. Exporting sectors in Mexico in 2000 had an average rate of utilisation of preferences of 64 per cent. This is consistent with Krueger (1999a) and others who suggested that NAFTA had only a modest effect on Mexican trade flows.
- Augier, Gasiorek and Lai-Tong (2003), looking at EU PTAs, found that rules of origin restricted trade for members, but where cumulation rules (to allow for multiple PTAs) were used, they enhanced trade (to the order of 50 per cent). They also found that the lack of cumulation is more important for trade in inputs, and that the higher the tariffs the smaller the impact of cumulation.

*Restrictive RoO are generally associated with high margins of preference and longer tariff phase-out schedules*

- Estevadeordal (2000) found that products subject to slower rates of tariff liberalisation tend to be associated with more restrictive RoO, which operate as a 'substitution' for the post-liberalisation effect. He noted that the degree of preferential tariff liberalization between the NAFTA partners is highly and significantly correlated with the degree of restrictiveness of RoO. Sectors with higher RoO are also the ones with longer phase-out periods for tariff liberalisation. See also Adams et al (2003).

*Restrictive RoO on final goods can encourage intra-PTA trade in inputs*

- Estevadeordal and Suominen (2003) found that restrictive RoO restrain trade and counteract the liberalising effects of PTAs. They also found that provisions like cumulation and drawback can encourage intra-bloc trade and, hence, reduce the negative effects of preferential RoO. At the sectoral level, their findings indicate that restrictive RoO encourage the use of intra-PTA inputs at the expense of extra-PTA inputs.
- Duttagupta and Panagariya (2001) showed that RoO divert demand for inputs towards higher cost PTA sources by distorting prices. They suggest that the overall impact of RoO is ambiguous as rules may lower or raise the joint welfare of the union. Work by Rosellon (2000) reached much the same conclusion.

(Continued next page)

Box 4.3 **(continued)**

*RoO have diverted resources from their most efficient uses*

- Appiah (1999) found that preferential RoO have distorted trade flows, diverting resources from their most efficient uses and reducing global welfare.

*Restrictive RoO can reduce the utilisation of preferences provided under PTAs*

- This has been shown in several studies of EU agreements. Brenton and Manchin (2002) found that, under the EU's 'Everything but Arms' agreement, only one-third of EU imports from the Balkans that were 'eligible' for preferences actually entered the EU at preferential rates. This primarily reflects the treatment of textiles and clothing products, which accounted for over 70 per cent of EU imports from countries covered by GSP, but where the utilisation was only 31 per cent. The low utilisation rate suggests that the RoO are restrictive to the point where many importers forgo the preference and pay the full MFN tariff rate.
- Estevadeordal and Miller (2002) also reported utilisation rates below 100 per cent between Canada and the US due to the tightening of pre-NAFTA RoO.

*RoO can act as an independent trade policy instrument*

- According to Falvey and Reed (2000), RoO are complementary to, rather than substitutes for, tariffs on final outputs. They operate as a substitute for a tariff on final outputs. This substitute relationship provides intra-bloc protection and thereby reduces the welfare of the members of the agreement.

An index methodology has been applied to NAFTA and to some EU agreements.[14] These studies focused on particular provisions of RoO by, for example, giving different weights to whether a change in tariff classification occurs at the chapter (2-digit), heading (4-digit) sub-heading (6-digit) or tariff item (8-digit) level. A change at the tariff item level is much more liberal than a change at the chapter level.

The Commission extended the range of provisions included in the RoO restrictiveness index to cover 11 index categories within three groups. The index decomposes the RoO-related component of the PTA Member Liberalisation Index discussed in Adams et al. 2003.[15] Details of the index are summarised in box 4.4.

[14] See, for example, Estevadeordal (2000); Brenton and Manchin (2002); Augier, Gasiorek and Lai-Tong (2003); and Estevadeordal and Suominen (2003).

[15] In that liberalisation index, a higher index value indicated a more liberal agreement. This study follows the convention adopted in analyses of restrictions in trade in the services trade (for example, McGuire et al. (2000), Nguyen-Hong (2000) and Kalirajan (2000)) whereby a higher index value indicates more restrictive (less liberal) provisions.

Box 4.4 **The restrictiveness index**

The overall index score for a particular set of RoO reflects the number of restrictions that are applied and the relative importance of those restrictions. The higher the overall index, the more restrictive is the trading regime for the members of that PTA. Within each restriction category, a score is assigned to the particular category of origin determination. The score ranges from 0 (least restrictive) to 1 (most restrictive). Each category also receives a weighting that indicates the relative restrictiveness of that category on the aggregate merchandise trade and firms' economic efficiency. The results for all relevant RoO provisions are normalised to a scale of zero to 1. The higher the weighting, the more restrictive an origin category is considered to be, relative to other categories. However, it needs to be appreciated that the information base for compiling the index — for example, for nominating the weights to be used — is limited. The results should therefore be seen as indicative of orders of magnitude, rather than as a precise measure of restrictiveness.

The index results show variation in RoO restrictiveness across PTAs. This variation and the uneven incidence of the RoOs across PTAs are likely to affect the extent and the pattern of merchandise trade between the member and non-member economies in association with their external tariffs.

Compared with the level of relative restrictiveness identified for other PTAs, the index suggests that CER has low to moderate RoO restrictions (figure 4.1). RoO with the highest index values, including NAFTA, MERCOSUR and EU–Poland, tend to be associated with regimes that adopt multiple criteria and more restrictive variants of individual criteria.

FINDING

*Compared with RoO in other PTAs, CER RoO are relatively 'clean' — that is, they are relatively free of deliberately restrictive rules.*

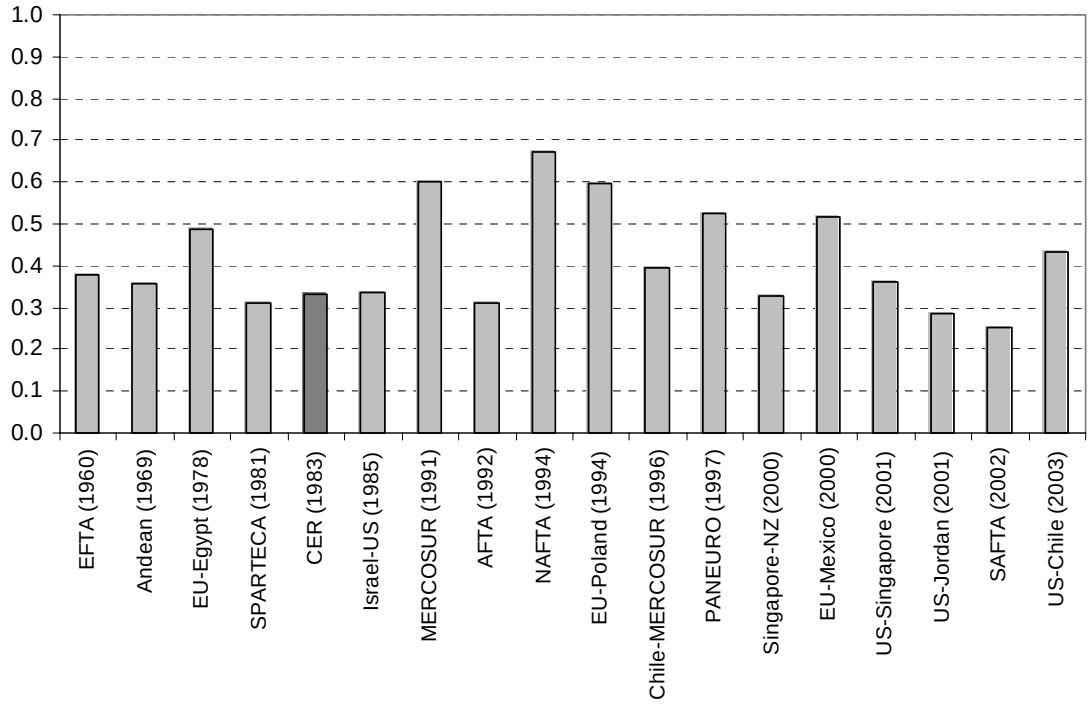
It needs to be recognised that the impact of RoO will vary because other factors influence trade outcomes — for example, each PTA member country typically has different MFN tariff levels with non-members and different tariff reduction schedules among members. In addition, the binding nature of RoO requirements differs across PTAs as a result of other administrative constraints imposed by them.

The analysis indicates that more restrictive origin rules tend to be associated with PTAs where member countries have higher average tariffs and where the differences in MFN tariff rates within each member country are also relatively high. It is in such circumstances that RoO tend to have the largest impact on the direction of trade and allocation of resources. Figure 4.2 shows how Australia's tariffs compare with those in New Zealand and with selected other economies (using data for 1996 to facilitate cross-country comparisons). Interestingly, for many tariff items in most of the comparisons, MFN tariff

rates were within 5 percentage points of the Australian rate. Nevertheless, for a significant minority of items — a majority in the case of Thailand —the tariff differences were substantial.

Figure 4.1 **Restrictiveness of preferential RoO in selected PTAs**

Index score ranges from zero (least restrictive) to 1 (most restrictive).




*Source:* Productivity Commission estimates.

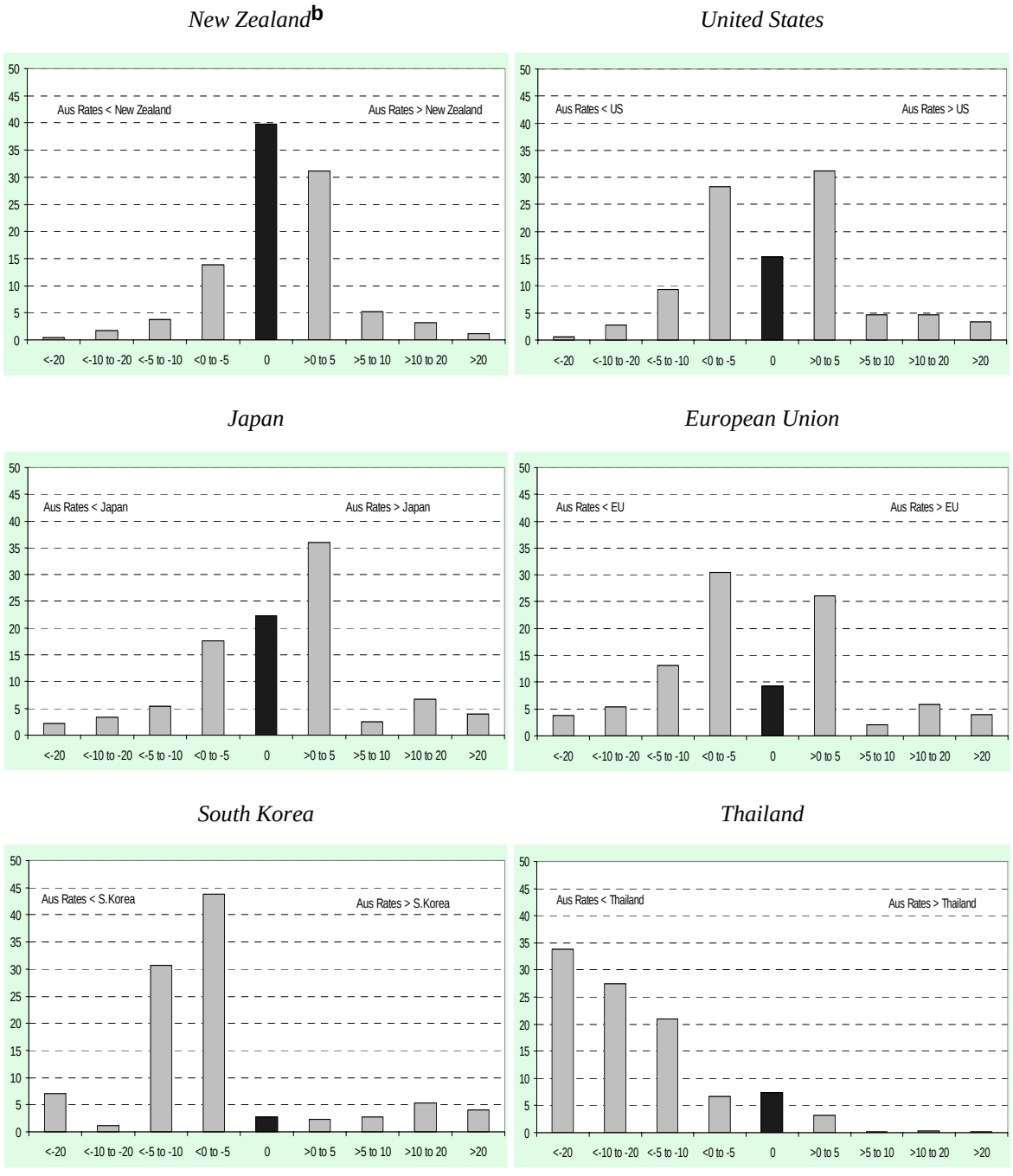
## The assistance provided by CER tariff arrangements

Several submissions highlighted the differences in tariff regimes between Australia and New Zealand and their impact on the implementation of RoO (see chapter 5).

As a result of these differences, CER assists some producers while disadvantaging others. For example, manufacturers of jumpers are protected by MFN tariff rates of 25 per cent in Australia and 19 cent in New Zealand. Under the CER, Australian producers face increased competition in their home market from duty free New Zealand imports. And, in the New Zealand market, they can in principle do no more than price up to the international price of jumpers plus the tariff of 19 per cent — compared with a 25 per cent mark-up in the Australian market. On the other hand, New Zealand producers receive higher protection against imports in the Australian market (25 per cent) than in the New Zealand market (19 per cent).

Figure 4.2 **MFN tariff comparisons, Australia and selected economies, 1996[a]**

Percentage of tariff items




**a** The Australian MFN tariff differential with the designated country had been calculated as the Australian applied rate (MFN basis) minus the designated country MFN rate for each tariff item. Zero indicates that the tariff items have the same applied rate in Australia and the designated country. Less than zero indicates that the MFN rates were higher in the designated country than in Australia. Greater than zero indicates that the Australian rates were higher in Australia than in the designated country. **b** The comparison of Australia and New Zealand data is based on the ABS and NZ statistics for 1995-96. This table is not strictly comparable with more recent data reported in chapter 2.

*Sources:* OECD (2003b), ABS (*International Trade, Australia*, Cat. no. 5465.0) and NZS (2003).

Even when tariffs are lower, these effects are present. For example, Australian manufacturers of biscuits are protected by an MFN tariff rate of 5 per cent, while the MFN rate in New Zealand is 7 per cent. This opens up the prospect that Australian biscuits can be priced at 7 per cent above international prices in New Zealand, rather than the 5 per cent margin possible in Australian.

Thus, preferential access by Australian exporters to the New Zealand market extends the tariff and other border protection otherwise reserved for local producers. Similarly, preferential access by New Zealand exporters to the Australian market extends protection to New Zealand exporters.

To date, estimates have not been made of the assistance implications of CER tariff concessions. The Commission has attempted to fill this gap by measuring the assistance afforded by CER tariff concessions which is additional to that provided by the respective tariff regimes in each country. The analysis indicated the following.

- Output assistance to CER exporters raised manufacturing industry assistance slightly in both countries. Average assistance to output of Australian and New Zealand manufacturers was estimated to have been raised by 0.04 and 0.4 percentage points, respectively, in 2001-02.
- The potential impact on the cost of material inputs appears to be minimal as most trans-Tasman trade in material inputs is in items with a general tariff of zero in Australia and New Zealand, thereby limiting the scope for the CER to affect material costs and thereby the assistance afforded to the inputs. Trans-Tasman freight costs appear to be relatively more important in influencing the material costs.
- With tariff reductions in Australia and New Zealand, the extent of additional tariff assistance available has declined.

The analysis also indicates that tariffs on inputs of materials from third countries tend to be greater in Australia than New Zealand. Australian exporters to New Zealand — particularly of TCF products — thus have most to gain from duty drawback and related schemes that lower the cost of exporting. Moreover, budgetary assistance to manufacturing industry is significant in Australia but negligible in New Zealand.

## 4.5 International developments

The competing tensions of liberalisation and restrictiveness created by PTAs highlight the two-edged nature of so-called ‘free trade’ areas because, while they remove tariffs for member countries, they also maintain (and will tend to increase) the relative handicap that non-member countries suffer in the market of the member countries. This implies protection against them:

> Discrimination in favour of one country discriminates against all others. Any preferential trading arrangement tends to promote trade among the participants, but at least partly at the expense of trade with others. (Snape, Adams and Morgan 1993, p. 14)

As the OECD observed, third country suppliers are not simply denied the preferential access provided for under the PTA, 'in practice they often lose access altogether' (OECD, 2002, p. 136). Indeed:

> … the most serious way in which PTAs risk trade diversion is through the tendency to accommodate enhanced post-PTA competition from a member of the PTA, not by reducing one's own uneconomic, high-cost production, but by raising barriers against more efficient nonmembers and reducing their exports to oneself. (Bhagwati 2002, p. 110)

With the increasing number of PTAs, there are now many countries which have separate, differently-specified RoO with different trading partners. This has led to a complex system of 'criss-crossing' trade preferences where products entering a particular country enjoy access on widely varying terms depending on their origin, leading to a 'spaghetti bowl'[16] or 'hub and spoke'[17] effect.[18] It arises because each member of a PTA maintains its own external tariff. This further complicates the economics of RoO. (This has implications for policies about 'cumulation' — see chapter 3.)

## 4.6 Concluding comments

There is mounting theoretical and empirical evidence that the economic effects of RoO are pervasive and significant. The proliferation of PTAs and supporting RoO can only add to this complexity.

When countries decide to enter into a PTA, the nature of the RoO used can have a major impact on the outcomes from the PTA. RoO which minimise trade restrictions and which provide scope to improve the allocation of resources and productivity within an economy offer the best opportunity for welfare benefits to be generated.

The process of setting and reviewing RoO is an important issue — particularly for those for whom particular formulations of RoO confer assistance. The process of negotiating RoO can be unduly influenced by such considerations (chapter 3) and, depending on the

16 Bhagwati (1995).

17 Wonnacott (1996).

18 The WTO observed that 'Most worrisome is the reality that the world's two major economic players, the United States and the European Union, are often the main drivers of this … — two 'hubs' with preferential trade 'spokes' radiating outwards' (Moore 2000).

size of the trade barrier involved (commonly, the height of the MFN tariff[19]), the transfers to particular groups can be large. Such transfers come at the expense of others in the community.

19 In some cases, quotas may also apply, so the option of bypassing preferential treatment and paying the tariff may not exist.

# 5 Problems with CER rules of origin

This chapter reports on problems with the design, implementation and enforcement of the CER RoO. It focuses on specific concerns raised by interested parties and on other potential shortcomings identified by the Commission.

The first section of the chapter presents some background information on the sectors affected by CER RoO and an outline of their major concerns. Sections 5.2 to 5.6 discuss particular problems with the design and operation of the rules. Section 5.7 deals with the implications for RoO of differences in Australia's and New Zealand's tariff regimes and other customs procedures. Section 5.8 outlines measures which have been considered by the officials' group (chapter 1) — some of which have already been implemented by New Zealand and some of which are still being developed. Other changes may also be agreed to, or implemented, before the Australian Government considers this report. Some concluding remarks are provided in section 5.9.

## 5.1 Background

Many firms in Australia and New Zealand are clearly benefiting from the improvement in market access provided under CER. The Australian Industry Group said:

> The overwhelming majority of Australian manufacturing companies believe that CER promotes a healthy business and trade relationship between Australia and New Zealand. Furthermore, the current ROO test not only supports this outcome, but is indeed seen by Australian industry as a fair test of origin. (sub. 4, p. 4)

However, many problems with the rules have also been raised. Generally, there would appear to be greater concern from New Zealand than from within Australia. This may partly reflect the importance of the larger Australian market to New Zealand exporters (see chapter 2). Business New Zealand noted that:

> … the rules of origin are a significant barrier to trade for a number of manufacturers and are becoming increasingly costly and difficult to adhere to. … the 50% local content requirement is becoming increasingly onerous for manufacturers who export to Australia. … [the rules] impose an impediment to efficient production … (sub. 7, pp. 3, 5, 9)

The Australian Industry Group stated it is:

> … not aware of any Australian companies that have difficulty meeting the 50% local content threshold. (sub. 4, p. 4)

However, Coles Myer, which said that it indirectly represents numerous small and medium-sized firms engaged in trans-Tasman trade worth $26 million, commented that uncertainty surrounding origin determinations is a major concern to their activities:

> … the interpretations attaching to the 'last place of manufacture' and qualifying content are a constant cause of uncertainty. This is notwithstanding the good faith declarations of manufacturers and the best efforts of all parties along the supply chain to understand and comply with the rules. (sub. 31, p. 1)

Some firms were concerned mainly with the additional competition that they would face from New Zealand exports if the current CER RoO were liberalised, and the differing interpretations of the RoO by Australian and New Zealand Customs (for example, the Harold Boot Company (sub. 11, p. 1) and TFIA (sub. 12, pp. 3–4 and 8 and sub. 34, p. 1).

Some exporters were concerned that the current RoO raise their costs, do not reflect the current structure of industry and are an impediment to the international competitiveness of Australian firms. Country Road (sub. 22, p. 6) noted that, while both governments encourage firms to adopt 'best practice' principles and improve efficiency in order to be able to compete on a world scale, achieving this can decrease a firm's eligible content component. It added that:

> … both trans-Tasman governments need to recognize that the adoption of the 50% rule was done in a totally different manufacturing context than that existing today and appropriately needs to be reviewed in light of current component global sourcing attitudes, the need to out-source manufacturing labour, technological change and improved business practices. (sub. 22, p. 6)

Early in the study, Australian TCF exporters, Hot Clothing and Cue Design, raised concerns about the restrictiveness of the last place of manufacture test and the treatment of certain expenses. Hot Clothing argued that aspects of the rules and their implementation were:

> … patently ridiculous and not in the spirit and intent of CER … (sub. 18, p. 2)

The textiles, clothing and footwear (TCF) sector (in both economies) expressed the greatest concern about the RoO. This is likely to reflect a number of factors, including the above average preference margins on some TCF items, the importance of the trans-Tasman trade for exports by this sector and the sourcing of some inputs from outside the producing country. The TFIA (sub. 12, p. 3) and the Carpet Institute of Australia (sub. 14, p. 1) submitted that New Zealand is the largest export market for Australian TCF firms.

Concerns about the RoO are not confined to the TCF sector. Some firms and associations from the appliance, pharmaceuticals, chemicals and plastics manufacturing industries made

similar points in submissions or in consultations. The Australian Plastics and Chemicals Industries Association (PACIA), for example, expressed concern about the RoO and about the different impacts on Australian and New Zealand firms of duty drawback and third country dumping.

The RoO have changed very little since the CER Agreement came into force 20 years ago. In that time, substantial changes to tariff levels, business models and technology and trade have occurred. Several of the key problems with the operation of the CER RoO stem from these changes. The prescriptive nature of the RoO has meant that the rules have not been flexible enough to adapt to evolving market conditions and production techniques. In this context, the New Zealand Government agencies submitted:

> The change in external tariff settings, contrasted against the largely unchanged RoO, have seen the RoO become an increasingly perverse constraint on the drive for increased manufacturing and broader business efficiencies not only in the trans-Tasman market but also with respect to the ability of individual firms to compete in international markets. (sub. 20, p. 4)

FINDING

*Problems associated with the current CER RoO are of greater concern for Australian and New Zealand firms and industries that are export-focused. Many of the concerns relate to trade in TCF goods.*

The major specific problems identified with the operation of CER RoO include:

- the inconsistent treatment and/or interpretation of RoO by Customs agencies in Australia and New Zealand (section 5.2);
- the restrictiveness of the 'last place of manufacture' test, including problems with the treatment of outsourcing and commission (ie contract) work (section 5.3);
- the disincentive to improve efficiency/reduce costs (section 5.4):
- the disincentive to use high value imported materials (section 5.4);
- the incentive to incur local costs to achieve the 50 per cent threshold (section 5.4);
- the treatment of specific material and overhead expenses in factory cost calculations (section 5.4); and
- the level of compliance and, connected with this, the adequacy of enforcement measures (section 5.5).

## 5.2 Inconsistent implementation

While the specification of the RoO in legislation and its implementation in both countries are almost identical in most respects, there are some important differences. Australia's Department of Foreign Affairs and Trade (DFAT) noted that:

> … there can, and have been, differing interpretations by Australia and New Zealand. (sub. 10, p. 2)

New Zealand Customs acknowledged that:

> … there is some inconsistency … between the Customs Services of Australia and New Zealand in their administration of the … rules … (sub. 21, p. 2)

PACIA stated that 'the rules are not being implemented in a fair fashion' (sub. 15, p. 2). Textile Bonding, a New Zealand manufacturing company, submitted:

> Currently there is a difference in interpretation of origin requirements between the two Customs Administrations … This difference in interpretation has caused a great deal of confusion between companies on both sides of the Tasman … (sub. 2, p. 3)

The most significant differences in the implementation of the rules between the two countries relate to:

- the circumstances in which Australian/New Zealand Customs will determine (impute) a value for materials supplied free of charge or at less than normal market value; and
- the method for calculating the percentage of local content for materials and inner containers of mixed origin (incorporating both imported content and content from Australia/New Zealand).[1]

The result of these differences, which are discussed under separate headings below, is that the same goods in the same circumstances receive different treatment depending on whether they are being imported into Australia or New Zealand. This is a significant concern for some firms on both sides of the Tasman and is contributing to confusion and uncertainty.[2]

FINDING

*Some aspects of CER RoO — notably the valuation of materials supplied at less than market value — are not implemented consistently by authorities in Australia and New Zealand.*

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1 There are also some differences in approaches to compliance and enforcement, and review and appeal procedures.

2 As the differences have been referred to the parallel officials' review (chapter 1), it is possible that some recommendations to alleviate the problem will be made in that review before the Government considers this report.

## Imputation of value for materials supplied free of charge or at reduced cost

Where materials, either local (CER) or imported, used in the production of the final good are supplied free of charge or at a cost that is less than the normal market value, Customs (in both countries) have the power to determine (impute) a value for those materials.[3] It is common for materials to be supplied free of charge when a sub-contractor is engaged to undertake a stage of processing on a commission basis (discussed in section 5.3). In such cases, the principal would typically retain ownership and control of the materials.

There is an important difference between New Zealand and Australia with respect to the circumstances in which Customs will impute a value for materials:

- Australian Customs can impute a value for the materials only when they have been effectively supplied ('arranged, directly or indirectly') by the eventual importer of the finished goods for which preference is claimed; whereas
- New Zealand Customs can impute a value of such materials, even where the eventual importer is not supplying or arranging for the supply of the materials.

This inconsistency was introduced into the rules following the 1992 CER Review. New Zealand Customs explained that 'an inadvertent divergence occurred in the understanding of each Party of what was intended' (sub. 21, p. 3).

Imputation of a value of materials (where the imputation results in a higher cost being included in factory cost calculations) adds to qualifying expenditure and thereby helps exporters when those materials are obtained locally. Conversely, imputation disadvantages exporters (by making it more difficult to meet the 50 per cent CER content requirement) when Customs imputes a value for imported materials.

Where Australian Customs does not impute a value for imported materials supplied free of charge to a New Zealand preference-good manufacturer, the value of these imports is not included in the factory cost calculations.[4] Thus, only the 'other' materials used by the 'manufacturer' (which could be limited/of low value) and qualifying factory overheads and qualifying labour (all local content) would be included, thereby ensuring close to 100 per cent qualifying content and guaranteeing preference eligibility for the finished good.

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[3] The amount determined by the CEO of Customs is based on an estimate of the normal market value for those materials. The CEO of Customs, in both countries, may also make a determination where the cost of materials to the manufacturer exceeds the normal market value. The amount determined to be the 'excess' may be excluded from the calculation of the factory cost. The Commission did not receive any evidence to suggest that these provisions relating to excessive costs have been implemented inconsistently across the two jurisdictions.

[4] That is, excluded from both qualifying materials (numerator) and total materials (denominator).

The anomaly is of particular concern to the textile finishing and clothing industries where the practice of outsourcing some final processes (such as cut, make and trim) is widespread and the fabrics used are often imported high quality/high cost materials. When the materials supplied to the designated 'manufacturer' have been imported from outside Australia/New Zealand (and the importer who claims the preference on the final good is not involved in the supply of the materials), the Australian exporter is disadvantaged relative to a New Zealand exporter.

Textile Bonding called for 'uniformity in interpretation as between Customs Administrations' (sub. 2, p. 3). A case study based on the experience of this New Zealand firm is included in box 5.1. It shows how the treatment of imported materials by Australian Customs favours outsourced final processing in New Zealand relative to integrated production in a single factory in that country, and relative also to the treatment of Australian exports to New Zealand (whether based on outsourced production or integrated processes).

This problem of inconsistent treatment has been recognised by authorities in Australia and New Zealand. Australia's DFAT suggested how the inconsistent treatment could favour New Zealand exporters:

> As a result of the application of the Australian provisions to a situation in which the final process of manufacture is outsourced, goods will almost always meet the 50 per cent rule, including where foreign material costs exceed the combined labour and overhead costs of the factory and the outsourcing business. This is because the costs incurred directly by the final "factory" or "manufacturer" normally relate only to their own labour and overheads, which are all local content. (sub. 10, p. 3)

DFAT added that:

> Put simply, the New Zealand regulations make it much more difficult to qualify for preferential access than the Australian legislation. (sub. 10, p. 3)

Box 5.1 **One firm's perspective on differences in the treatment of intermediate materials in outsourced processing**

Textile Bonding Ltd is a specialist New Zealand manufacturing company serving curtain wholesalers by back-coating fabrics with a 'Thermal' backing. The following extracts from the company's submission (sub. 2) illustrate the implications of the different treatment by New Zealand and Australian Customs of intermediate materials used in outsourced processing.

When Textile Bonding directly imports fabrics (from outside the CER area), back-coats them in a fully integrated operation, and exports the finished good to Australia, the full cost of the imported fabric must be included in the factory cost calculations as non-qualifying expenditure.

On the other hand, when Textile Bonding is contracted to undertake back-coating of fabrics (the last process of manufacture) on behalf of another firm in New Zealand, and that other firm supplies the imported fabric free of charge to Textile Bonding, Australian Customs disregards the value of the imported fabric when assessing factory cost and preference eligibility for the finished good.

> In effect this means that coated fabric, with a less-than-50% CER qualifying content, that has been coated in New Zealand is duty-free when exported to Australia by a New Zealand company other than the coating company. This situation quite clearly disadvantages the manufacturer (Textile Bonding Ltd) because its Australian customers are penalised and … is contrary to the intent of CER. (p. 3)

Textile Bonding pointed out that, for exports from Australia, New Zealand Customs imputes a cost for imported fabric if it has been supplied to the 'manufacturer' free of charge or at a cost that is less than the normal market value. Textile Bonding stated:

> New Zealand Customs includes the cost of imported fabric in its ex-factory calculations for goods exported to Australia. This difference in interpretation has caused a great deal of confusion between companies on both sides of the Tasman in recent times … (p. 3)

The firm also noted how the different treatment by Australian and New Zealand Customs could particularly disadvantage an Australian business that supplies imported fabric directly to Textile Bonding for coating, prior to importation into Australia of the treated fabric, by the same Australian business.

> Unlike his New Zealand competitor [exporting to Australia], where an Australian business is involved directly or indirectly in the provision of that fabric, the Australian Customs Service requires the cost of that fabric to be determined by the Customs CEO. (p. 3)

*Source:* Textile Bonding (sub. 2, p. 3).

The Australian Department of Industry, Tourism and Resources (DITR) informed the Commission that:

> At present, under Australian law, much of the imported content going into the final process is disregarded where the last process [in NZ] is outsourced. This is recognised as a possible defect in our law and action is in train to examine changes. (sub. 16, p. 3)

## Treatment of mixed-origin materials and containers

There are significant differences between Australia and New Zealand in the treatment of mixed origin materials (ie those which have components from within and outside the CER area) and inner containers (eg cardboard boxes)[5] in the calculation of allowable expenditure.

Australian Customs (for imports from New Zealand) calculates the percentage of local content in intermediate materials of mixed origin as the sale price of the input minus the cost of the imported content of the input. This calculation is based on the so-called 'transaction value build-down' method of determining local content (see chapter 8). Inner containers are treated in the same manner.

On the other hand, New Zealand Customs (for imports from Australia) calculates local content using the factory cost method (ie in the same manner as the final good). Inner containers are treated as a separate item of factory cost and must have at least 50 per cent Australian and/or New Zealand content before they can be treated as allowable expenditure.

Both Australia and New Zealand treat materials of mixed origin which reach 50 per cent or more local content as 100 per cent qualifying materials. In such cases, the alternative methods for calculating the local content in the materials will not have a different impact on the origin determinations of finished goods where the local content in the material is calculated to be 50 per cent or more.

Where the 50 per cent local content of materials is not reached, however, the different methods can have a significant impact on the value of qualifying expenditure on materials and, hence, eligibility for duty concessions. In this situation, the local content calculation determines the *actual* portion of the cost of the material that is allowed to be treated as qualifying expenditure in the factory cost calculation for the finished good (box 5.2). The different treatment favours New Zealand exporters relative to Australian exporters, because the calculation method used by Australian Customs is more liberal — it includes *all* expenses, other than the cost of imported materials, as qualifying local content, whereas New Zealand Customs excludes 'certain' factory expenses not related to the manufacture of the materials. This difference increases the numerator in the Australian calculations (for New Zealand exports) relative to that in the New Zealand calculations (for Australian exports). In both cases, the denominator in the factory cost calculation for the finished good includes the total selling price of the material into the factory.

5 Includes any container that finished goods are packed into 'other than pallets, containers or similar articles which are used by carriers for cargo conveyancing' (Australian Customs 2003a, p. 9).

Box 5.2 **Impact of the different treatment of mixed origin materials by Australia and New Zealand**

The following example illustrates the impact of the different treatment of mixed origin materials.

| | | |
|---|---|---|
| A. | Cost of imported materials | $120 |
| B. | Cost of materials manufactured in Australia/New Zealand | $30 |
| C. | Labour and factory overhead for manufacture of materials | $40 |
| D. | Total factory cost of materials (A+B+C) | $190 |
| E. | Other overhead and profit, including freight (not related to manufacture) | $60 |
| F. | Selling price of material to the factory where the goods on which the preference is claimed are manufactured | $250 |

***New Zealand Goods exported to Australia*** *(deduct imported materials method)*

Local content in material = F ($250) – A ($120) = $130

As local content is more than 50 per cent of F (that is, $130/$250 = 52%), 100 per cent of the value of the material is qualifying expenditure = **$250**

***Australian Goods exported to New Zealand*** *(factory cost method)*

Local content in material (B+C) = $70

Local content/total factory cost (D) = $70/$190 = 37%

Qualifying expenditure on materials = 37% of F ($250) = **$92.50**

Because the 50 per cent local content is not achieved in this case, only a portion of the cost of the material is allowed to be treated as qualifying expenditure by the manufacturer of the goods on which preference is claimed, viz: $92.50. This works out at only a little over one-third of the qualifying expenditure allowed to be included by the importer of the equivalent New Zealand goods.

*Source:* Adapted from New Zealand Customs 2003b.

The more liberal treatment by Australian Customs can significantly increase the chance of materials of mixed origin reaching 50 per cent local content (resulting in the full value of the materials being counted as qualifying expenditure). In turn, this can significantly improve the prospect of obtaining preferential entry for the finished goods, relative to equivalent goods exported from Australia to New Zealand (box 5.2).

Harold Boot Company considered that the treatment of mixed origin materials by Australian Customs is too generous and that:

> It would be preferable for the qualifying area content in all cases to be in direct proportion to the actual area content, ie if a material has a 50% area content, then 50%

of the expenditure on that material would be included as qualifying content of the final good. (sub. 11, p. 1)

## 5.3 Difficulties with last process of manufacture requirement

Under the CER RoO, the last process of manufacture must be performed by the 'manufacturer' in either Australia or New Zealand. This requirement creates a number of difficulties for manufacturers/importers seeking to satisfy origin requirements. The main problems relate to determining what constitutes 'manufacture' and the treatment of outsourced production and commission work.

### What constitutes manufacture?

The term 'manufacture' is not defined in the CER Agreement or the relevant New Zealand or Australian legislation and regulations covering the RoO. Guidance materials include broad statements about what is required and identify examples of 'minimal operations or processes' that do *not* by themselves constitute manufacturing (box 5.3). The lack of legislated guidance has resulted in a degree of uncertainty surrounding what constitutes manufacture and has the potential to impose unnecessary costs on both firms and Customs.

The *Jolly O* case[6] demonstrated the potential restrictiveness and possibly counter-intuitive nature of the 'last place of manufacture' rule. Despite substantial work in New Zealand — that comfortably passed the CER value threshold criterion — the import of the vessel 'Jolly O' was not eligible for preferential entry. It was deemed that the 'last place of manufacture' was the original building of the boat, not the upgrade, however substantial. The decision by the Australian Administrative Appeals Tribunal not to classify the work undertaken in New Zealand as manufacturing appeared at odds with the classification of similar processes within standard industrial classification systems, as applied in the Australia and New Zealand Standard Industrial Classification (ANZSIC) — where the activity would be classified to manufacturing class 2822 (Boat building).

In response to this, the interim report suggested that decisions about what constituted manufacturing should be based upon the activities that are classified to the ANZSIC manufacturing division. However, many participants questioned how the ANZSIC would be used in practice and whether it would be rigorous enough to ensure that goods with only minor processing are not granted preferential treatment. Some agreed there was a problem with the current definition — for example, the Distilled Spirits Industry Council of

6 *Re Regal Holdings Ltd and CEO of Customs* (1997) 46 ALD 373.

Australia said that the lack of a definition of manufacture in the CER agreement created uncertainty for the spirits industry (sub. 39, p. 1).

Box 5.3 **Customs' guidance on 'manufacture'**

The Joint Australia/New Zealand Customs Information Booklet 'Rules governing entitlement to preferential rates of duty for trans-Tasman trade' defines 'manufacture' in the following terms:

> In essence, manufacture involves the creation of an article different from the component parts or materials which go into such manufacture. Repairing, re-conditioning, overhauling or re-furbishing do not constitute manufacture as these are restoration processes.
>
> Minimal operations or processes such as pressing, labelling, ticketing, packaging, preparation for sale and quality control inspections will not, by themselves, be considered to be the last process of manufacture. However, where the last process of manufacture has been performed, the cost of these operations or processes may, in some cases, be considered as local area content. (Australian Customs 2003a, p. 6)

A fact sheet, published by New Zealand Customs, but produced jointly with Australian Customs, states:

> Manufacture involves making one thing out of another, the new being essentially different in character, identity, form, function, description and commercial understanding from the other.
>
> Manufacture must involve a significant change in the form or function of the thing said to be manufactured, compared with its unmanufactured or previously manufactured state. Essence of making or of manufacture is that what is made shall be a different thing from that out of which it is made. (New Zealand Customs 2003b, p. 2)

*Sources:* Australian Customs (2003a) and New Zealand Customs (2003b).

Following from this, some participants suggested an examination of the case law surrounding the interpretation of the term 'manufacture'.

Further, DITR doubted that there was a need to change the definition of manufacture as it 'has been refined and clarified by Australian case law' and has a 'degree of stability' (sub. 28, p. 4). However, through consultations and roundtable discussions, it became clear to the Commission that different participants have quite different views on what precisely is entailed by the current definition of manufacture.

### *Common law meaning of manufacture*

Under the CER agreement and the Customs Act, the term manufacture has to be interpreted according to the meaning ordinarily attributed to it.[7] The Australian Customs manual (Australian Customs 2003c) adds that:

[7] As approved by *Re Regal Holdings Ltd and CEO of Customs* (1997) 46 ALD 373 (*Jolly O* case). This case is the only one that deals specifically with the definition of manufacture under the CER

> … what is ‘manufacture’ in any particular case must be determined on a case-by-case basis with due regard being paid to the nature of the goods concerned and processes to which they have been subjected. (p. 214)

The ordinary meaning of manufacture has been examined by numerous High Court and Federal Court decisions, and as noted by both courts, the scope and nature of the legal conception of manufacture is not in dispute and has long been accepted.[8]

The common law meaning of manufacture focuses on the creation of a commercially distinct final good (see box 5.4). An analysis of the case law on the definition of manufacture is contained in appendix C. This demonstrates that manufacture occurs when a good is produced which is commercially distinct from the materials which were used in its production. For a good to be commercially distinct, it has to be distinct in its physical characteristics as well as its utility for some purposes. While the law is settled and clear, the application of it to particular cases can at times be quite difficult — as noted by the Federal Court, the large number of cases dealing with particular processes ‘are largely without precedential value, as they all depend upon their own facts’.[9]

FINDING

*The definition of manufacture used in CER RoO is well established and has long been accepted. However, the application of the definition to particular cases can at times be difficult and is subject to case-by-case interpretation.*

agreement. Another AAT case, *Re Gaylor Jewellery Pty Ltd and Collector of Customs* (1990) 12 AAR 86, while dealing with the CER RoO, centred around the definition of ‘allowable materials’ rather than ‘manufacture’.

8 *Commissioner of Taxation v Softex Industries* (2001) 191 ALR 724 (*Softex*) and *Commonwealth v Genex* (1992) 110 ALR 154 (*Genex*).

9 *Softex*, at p. 727.

Box 5.4 **A definition of manufacture from case law**

Using the terminology of Australian courts, manufacture can be defined as:

> A process that results in a good that is commercially distinct — in physical characteristics and in its utility for some purposes — from the thing or things which went into its production.

The term 'commercially distinct' was used in *Softex* to reflect the concept of difference in characteristics and utility from one good to another. It distinguishes between manufactured goods and other goods which may be distinct only in physical characteristics, including goods subject to minor processing, including distribution services, and is used here in the same sense.

According to this definition, processes that would not be regarded as manufacture include:

- assembly of parts;
- adding components or parts to an otherwise unfinished good;
- alteration of existing goods, which does not alter the nature of the good; and
- processes which make goods more saleable or attractive to potential customers.

*References: Commissioner of Taxation v Softex Industries* (2001) 191 ALR 724 (Federal Court); *M P Metals Pty Ltd v FCT* (1968) 117 CLR 631 (High Court); *Irving v Munro & Sons Ltd* (1931) 46 CLR 279 (High Court); *Re Tubemakers of Australia Pty Ltd and Collector of Customs* (1980) 3 ALD 199 (AAT); *FCT v Jack Zinader Pty Ltd* (1949) 78 CLR 336 (High Court).

## Treatment of outsourcing and commission work

Early in the study, a number of firms and industry associations in Australia and New Zealand raised concerns about the treatment of outsourced production under CER RoO. Work that is outsourced can be performed by another factory owned by the principal manufacturer or by an unrelated firm on a contract or commission basis. Cut, make and trim operations in the clothing sector, now commonly outsourced, are an example.

In addition to the problems concerning the inconsistent treatment of materials supplied to contractors free of charge (section 5.2), there is another, more fundamental, problem with the design of the CER RoO as it affects outsourcing. Specifically, when the principal manufacturer has the *last process of manufacture* undertaken by another factory, on a contract or commission basis, the expenditure (on materials, labour and overheads) incurred only by that last factory can form part of the factory cost calculation.[10]

[10] Where materials are supplied free of charge, Customs can include an imputed value for the materials, even though the 'manufacturer' has not actually incurred the expense.

A number of clothing manufacturers were particularly concerned about the exclusion from factory costs of substantial overhead expenses incurred by the principal prior to the last (outsourced) process of manufacture. They argued that this CER content, embodied in the full market value of the product, should be included.[11]

Cue Design, an Australian manufacturer of women's fashion garments, said that it incurs significant costs in the design and production processes that cannot be included in qualifying content under the 'last place of manufacture' rule because the final process is outsourced. The processes Cue performs:

> … initiate the whole production process and are essential to the manufacture of the garments. They include fabric development, sourcing and testing, design, pattern making, checking of pattern digitising and grading, garment construction and finishing instructions and quality control of garments. (sub. 6, pp. 1–2)

However, as Cue sub-contracts the final stages of cutting and making the garments to separate sub-contractors, it is the maker, not Cue, that is identified as the 'manufacturer' of the goods under this rule. Consequently:

> … all of Cue's costs are excluded from fwc [factory works cost] and qualifying content of all garments imported into New Zealand. (sub. 6, pp. 1–2)

New Zealand Customs stated:

> … save for materials supplied free of charge … non-material inputs [to the manufacturing process] the cost of which is incurred by some person other than the manufacturer (as defined) are excluded from the factory or works cost (fwc) and, ipso facto, from contributing towards qualifying content. (sub. 21, p. 3)

Cue submitted (p. 1) that under the 'last place of manufacture' rule (which Australia continues to use until legislative changes can be made), New Zealand Customs included 'the cost of fabric, accessories and cutting only, when assessing [imputing] the value of the … 'materials''. The design and other tasks performed by Cue Design *prior to* the final processing were, until recently, considered non-factory 'overhead costs' and therefore unable to be included as qualifying materials in the final garment. As a result, in such cases, substantial regional content was not counted in determining the final origin status of the finished goods. However, recent changes to New Zealand Customs regulation are intended to address this.

In contrast, in a fully integrated operation, where the design and all production processes are undertaken in-house, such costs can be included in allowable factory costs (according to Australia and New Zealand procedures). In addition, where an *intermediate* stage of

[11] This can offset the effect of imputation. As noted in section 5.2, where high cost imported fabrics are supplied to the sub-contractor, the imputation of a value for the material can make it difficult to satisfy the 50 per cent of factory cost requirement.

production is outsourced within Australia or New Zealand, the 'manufacturer' of the final good can include in factory overheads contracting-out costs.[12] Cue Design argued:

> Whether a portion of the manufacturing process is performed by a subcontractor or by Cue, should not affect the Australian content of any item. As long as the process is performed in Australia, the cost should be attributed to Australian content. (sub. 6, p. 3)

Similarly, Hot Clothing, another Australian clothing manufacturer, submitted:

> The place of manufacture should be defined as the country not the factory. (sub. 18, p. 3)

New Zealand Customs said that Australian and New Zealand Trade Ministers have recognised the need to address these issues:

> … there needs to be changes to legislation dealing with the treatment of outsourced or contracted manufacture and in this respect officials are currently contemplating rules that should pick up Cue's concerns regarding the exclusion of genuine local content from qualifying content. (sub. 21, p. 4)

Australian Customs said that:

> Australia and New Zealand intend to amend their respective legislation to address the issue of sub-contracting. (sub. 24, p. 4)

In January 2004, New Zealand amended its Customs regulations to take account of this issue by replacing the 'last place of manufacture' requirement with a concept of 'principal manufacturer'. This appears to solve the problem of outsourced production for Australian exporters to New Zealand. However, Australia is yet to change its law. Consequently, New Zealand exporters to Australia continue to operate under the 'last place of manufacture' rule.

FINDING

*The concept of the last place of manufacture has lost some relevance because of changes in the way firms organise their production.*

## 5.4 Regional content threshold (50 per cent rule)

The second part of the preference test is that not less than 50 per cent of the factory cost must be represented by the qualifying (allowable) expenditure of the manufacturer.[13] This section outlines problems raised about the regional content threshold and its determination.

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12 Australia — *Customs Regulations 1926*, reg 107B(1)(q); New Zealand — *Customs and Excise Regulations 1996*, reg 34(1)(c)(xiv).

13 The 'factory' is defined as the place where the last process in the manufacture of the goods was performed.

## Level of CER content threshold

A range of views was expressed by participants on the impact of the local content threshold level on their operations. A number of parties representing New Zealand interests considered that the 50 per cent CER content threshold was too high. For example, the Australian clothing manufacturer, Country Road, said:

> There are compelling arguments why a reduction in the content percentage should be considered seriously … (sub. 22, p. 7)

EMA New Zealand, submitted that:

> The current position of a 50% content rule of origin under CER causes considerable difficulty for businesses to comply with. (sub. 3, p. 3)

Fisher & Paykel considered that the increasing difficulty in obtaining some components from within the CER region justified a lowering of the threshold:

> The current threshold of 50% qualifying content is too high, given the developments in manufacturing technology and the virtual removal of the manufacturing infrastructure in New Zealand (and, but perhaps to a lesser extent, Australia) which previously supplied components to the whiteware industry. (sub. 23, p. 5)

Manufacturers (mainly from New Zealand) argued that the threshold is restricting trade in goods with significant local value added and which clearly involve a 'substantial transformation'. The New Zealand Government agencies stated that 'the area content threshold has been identified as the single most important issue by New Zealand businesses under the current RoO' (sub. 20, p. 10).

Other parties, including some firms and industry groups from Australia and the New Zealand Footwear Industry Association (sub. 8), argued that the current level did not pose any problems. DITR advised that the existing threshold has:

> … been consistently supported by major Australian industry associations including the Australian Industry Group, the Australian Chamber of Commerce and Industry, the Council of Textile and Fashion Industries of Australia, the Federal Chamber of Automotive Industries and PACIA [Plastics and Chemicals Industries Association]. (sub. 16, p. 4)

The Department also pointed out that the threshold is the same as the requirement in the *Trade Practices Act 1974* for determining where goods have been manufactured for the purposes of ss. 52 and 53 of the Act.[14]

Firms in the Australian TCF sector suggested that the current threshold should be maintained to protect them from competition from New Zealand imports produced using

[14] Section 52 — Misleading or deceptive conduct; and section 53 — False or misleading representations.

imported materials which incur a lower tariff than that on similar materials imported into Australia.[15] The Harold Boot Company (sub. 11, p. 1) went further, claiming that the 50 per cent requirement was 'too favourable to imported components' and should be replaced with a 75 per cent threshold.

> This would limit the extent to which essentially imported materials could be made into goods and then treated as 'Australian Made' or 'New Zealand Made'. (sub. 11, p. 1)

An important point, acknowledged by Country Road, is that changing the threshold:

> … only results in shifting the goal posts and does not address the fundamental flaws of the existing rules. (sub. 22, p. 7)

## Sensitivity to exchange rate movements

One of the most significant and widespread concerns about CER RoO is that origin determinations are sensitive to changes in prices and other factors that determine allowable factory costs. While this includes direct movements in material and labour costs and components of qualifying overheads (such as depreciation, interest payments and royalties), a major problem experienced by manufacturers is the effect on prices, and hence origin determinations, of fluctuations in exchange rates.

Several New Zealand manufacturers stated that the volatility of the New Zealand dollar in recent years had created substantial uncertainty with respect to origin/preference status, particularly for products already close to the 50 per cent threshold. EMA New Zealand told the Commission that 'exchange rate movements can dramatically impact on the ability of manufacturers to meet the current content rules' (sub. 3, p. 4). It stated:

> Most raw materials and many components are purchased in US dollars (although not exclusively) which means that any significant depreciation of the currency against the US increases the imported costs to the manufacturer. The impact of this can be such that the local content can be pushed below the 50% level when no change has occurred at the manufacturing end to change the content. This may mean that one month the content is above and the next it is below making it difficult for all parties to assess whether tariff should apply. The cost of this can be reflected in the final cost of goods and also in the costs the business must bear in order to trade across the Tasman. It certainly has an impact on forward planning and makes quoting on large orders particularly difficult when selling free into store. (sub. 3, p. 4)

[15] Certain textiles are duty free when imported into New Zealand, but equivalent imports are subject to duty in Australia. For some other textiles, import duties in New Zealand are lower than equivalent Australian duties. Furthermore, in the latter case, the New Zealand exporter can claim duty drawback, while its Australian competitor supplying the domestic market cannot. Australian exporters, of course, can claim drawback of duty paid on imported materials.

Industries that use significant quantities of imported inputs are particularly vulnerable to exchange rate movements. According to EMA New Zealand (sub. 3, p. 5), industry sectors in New Zealand that rely on substantial imported raw materials, partially manufactured materials or components and parts include: plastics, textiles, clothing, footwear, appliance manufacturers (gas and electrical) and automotive components.

PACIA (sub. 15, p. 6) submitted that exchange rate fluctuations are also having a substantial impact on the price of raw materials used by the Australian plastics and chemicals industry. Cue Design (sub. 6, p. 2) indicated that imported high quality fabrics account for a significant proportion of the total cost of its garments, and allowable expenditure is therefore very sensitive to exchange rate fluctuations:

> Within the previous 12 months, exchange rates for Cue's overseas payments have fluctuated between .529 to .69 for USD and .5424 and .5905 for Euros, creating a significant difference in the cost of an identical fabric imported at different times and consequently affecting the foreign cost/content of a garment; … (sub. 6, p. 2)

Exchange rate volatility can be especially problematic where production is sold in advance. This practice is typical in some parts of the TCF sector. Business New Zealand explained the problem as follows:

> The garment industry generally sells on 'indent' (that is, selling their product a season or more in advance), so have to make a decision at that time as to whether or not to pay duty. By the time the fabric arrives for manufacture, exchange rate fluctuations can often mean that the manufacturer may not have priced the garment correctly. Selling under indent can be a significant problem as the manufacturer cannot go back to the buyer and renegotiate a new price. (sub. 7, p. 7)

Cambridge Clothing told the Commission that about one-third of its sales are indented, with the typical cycle from customer order to garment delivery being about nine months (sub. 19, p. 2). Rembrandt Suits also found selling on indent difficult (sub. 38, p. 1).

Many firms engage in currency hedging (by purchasing forward cover) to help mitigate the risks associated with exchange rate movements. Business New Zealand, however, argued that many exporters do not use hedging for various reasons, including the size of transactions and the expertise required (sub. 7, p. 7).

Nevertheless, businesses that do not have the knowledge or confidence to manage their currency hedging have the option of engaging experts in the same way that they purchase many other professional services.

To partly address the unpredictability problem with the threshold regional content test (in particular due to exchange rate fluctuations), the CER RoO include provision for a margin of tolerance, of up to 2 percentage points, to be applied. This entitles shipments which have allowable expenditure of not less than 48 per cent of factory cost to duty-free entry. This is available only where unforseen circumstances (that are unlikely to continue for more than

three months) lead to a failure to achieve the 50 per cent threshold. However, a special application must be made, in writing, to the CEO of Customs for a tolerance determination. The application must be made well before the goods are imported, to allow sufficient time for Customs consideration. Also, the margin of tolerance is a one-off adjustment, and cannot be used where shipments would continuously just fail to meet the 50 per cent requirement. The Commission has been told that very few firms actually use this provision.

## Disincentive to reduce costs and improve efficiency

Where firms are successful in expanding production (for example, through the development of global export markets), average per unit overhead costs will tend to fall. Given that factory overheads can constitute a significant proportion of allowable expenditure (for determining preferences in the trans-Tasman trade), this can make it more difficult to satisfy the CER RoO. DITR submitted:

> The expansion of production and lowering of overhead costs would generally be seen as an improvement in economic efficiency and yet it can have the perverse effect under the factory cost approach of disqualifying a product from preference in the partner's market. The overall effect could be to discourage efficiency enhancing expansion. (sub. 16, p. 3)

The New Zealand Government agencies provided the following example:

> … a New Zealand company growing its operations in the US market puts its preferential access into Australia at risk because it is required to pro-rate an increasing proportion of its overhead costs to the US operation. This diminishes the proportion that can be counted towards trans-Tasman qualifying origin and hence lowers the area content level. (p. 7)
>
> Given that many successful trans-Tasman companies' long-term strategies are based on global growth strategies, the RoO are acting as a constraint on further business rationalisation for companies operating close to the qualifying area content threshold. This is particularly the case where the trans-Tasman market is today a company's most important market. The RoO accordingly penalise a company which seeks to use its trans-Tasman market base as a platform for global expansion. (sub. 20, pp. 8–9)

Under the CER RoO, lower-cost, more efficient, producers are effectively penalised. For example, if a firm cuts CER labour and overhead costs, its allowable expenditure would fall, pushing the firm towards the CER threshold. For firms that are already close to the threshold, this tends to discourage the development of innovative and efficient business practices and improved productivity. This point was highlighted in several submissions. Country Road noted that:

> … as your efficiency increases your eligible "content" component decreases. This is the major weakness of the area content test and can result in identical goods manufactured and exported by different companies being the subject of different tariff treatments. (sub. 22, p. 6)

Business New Zealand considered that:

> … the 50% local content requirement perversely discriminates against those manufacturers that want to make efficiency improvements in their production as doing so would make it even harder to stay within the limit. (sub. 7, p. 6)

Similarly, EMA New Zealand said:

> When manufacturers are aware of the need to maintain a minimum level of content there is a clear disincentive to improving efficiencies in the manufacturing processes where these might reduce the local content. This becomes particularly so when the local content is close to the threshold. Ultimately this impacts on investment and places the business in a long term disadvantage against international manufacturers who are able to make efficiency gains through technology or process changes. (sub. 3, p. 5)

Producers which use older, more expensive plant and are more labour-intensive find it easier to show high local content, whereas those with newer facilities using less people and computerised or more mechanised equipment generally have lower local content (other things being equal). The New Zealand Government agencies suggested that the RoO may be:

> … acting as an increasing constraint on the acquisition of new technologies that would improve the long run competitive position of Australian and New Zealand firms internationally. (sub. 20, p. 6)

## Disincentive to use high value imported materials

The CER RoO disadvantage firms with high imported raw material or component costs. For example, some TCF producers using high value imported fabrics experience difficulties meeting the origin requirements. Business New Zealand submitted:

> The 50% local content requirement prevents some companies from offering products made from higher priced fabrics, the great majority of which are sourced offshore and which have a significant negative impact on the local content. Fabrics have become a larger proportion of the total cost of garments over time, and with increased efficiencies and more sophisticated fabrics it has become more difficult for companies to remain within the 50% local content requirement. (sub. 7, p. 6)

Rembrandt Suits of New Zealand noted the possible implications for quality and consumer prices:

> To meet 50% content we at times purchase raw materials from local sources more expensively than is available from alternative world sources and of a lower quality. An example of this is polyester linings for a jacket - not only does this cost substantially more than the viscose lining we would prefer to buy but it is of inferior quality to the preferred option. The same applies to locally sourced shoulder pads and trouser pocketing. Consumers ultimately pay a higher price which does not seem to be the desired outcome of this regulation. (sub. 17, p. 1)

Rembrandt also emphasised the importance of the 'higher priced/higher quality end of the market' to the future prospects of the local garment industry and noted that the RoO:

> … in effect restricts us from manufacturing the items that are the most logical to be made locally and as a result the market place will buy the goods from the alternative sources which is likely to be European. This does not seem to be the outcome planned for the 50% local content level. (sub. 17, p. 2)

Similarly, the New Zealand Government agencies stated:

> The current RoO, based on ex factory cost, fail to account for changing consumer demand for broader ranges of fabric styles and designs. (sub. 20, p. 6)

Moreover, as DITR noted, a RVC requirement that involves significant regional content generates a:

> … bias toward low cost imports and consequently encourages production of lower quality goods. (sub. 28, p. 3)

Firms that are part of integrated global networks that can only (or most efficiently) obtain a major proportion of their material inputs from countries outside the CER region can find it especially difficult to achieve the necessary level of allowable expenditure. This outcome is even more likely if the firm's production process has a high materials to output ratio (for instance, because of a capital-intensive, highly automated process).

Thus, even where the manufacturing process that fundamentally transforms the good takes place wholly within the region, many such finished goods fail to satisfy the CER content.

Such an outcome is harsh where equivalent locally manufactured materials are not available. Cue Design highlighted this aspect of the problem:

> Australia and New Zealand manufacture a very small selection of fabrics. Cue is therefore forced to import over 150 fabric styles/designs from over 50 suppliers each season. Cue's market is the upper end of the younger market and many of the fabrics are high quality and expensive, therefore increasing the proportion of overseas costs compared to Australian costs. Cue has no alternative source for such a wide range of fabrics in Australia or New Zealand …
>
> Cue tries to source accessories from Australian manufacturers wherever possible. However availability is again an issue and in most cases there is no Australian equivalent to imported accessories. These all add to the foreign content of a garment. (sub. 6, p. 3)

Similarly, appliance manufacturer Fisher & Paykel indicated that:

> The Company now finds that innovative materials are not available in New Zealand and Australia and componentry such as electronics and specialist plastics and steel must be obtained from non-qualifying sources. (sub. 23, p. 4)

## Incurring of costs to achieve the threshold

The 50 per cent CER threshold also leads to somewhat arbitrary results for borderline cases — for example, a manufactured product with allowable expenditure equal to 48 or 49 per cent of total factory cost would be denied origin while a good with 50 per cent content is considered to originate within the region.[16] At the margin, there is a significant incentive for manufacturers and/or importers to add local content just for the sake of ensuring the desired origin determination. This is adding significant costs and inefficiencies to manufacturing processes.

Business New Zealand told the Commission:

> Failure to comply can potentially be extremely costly and in the case of garments companies often have to resort to other ways of making the product compliant, such as by including hangers, belts etc. (sub. 7, p. 5)

Similarly, Rembrandt submitted:

> … in some circumstances we manufacture garments to a quality standard far higher than is required by the market just to ensure we meet the 50% level — in one extreme case … we also deliver the garment with a belt (made in NZ) just to ensure we meet content. (sub. 17, pp. 1–2)

Cambridge Clothing has implemented an active system that measures the proportion of CER cost content in each individual product before 'making' orders are issued. The system produces daily reports identifying items that may not qualify for preference. This allows the firm to:

> … add or substitute alternative components that bring the item above the qualification bar. This outcome is better than paying the duty because it reduces the loss of margin, and in some cases adds at least some customer value. (sub. 19, p. 2)

Rembrandt also noted that the 50 per cent content requirement leads to additional costs of managing inefficient quantities of raw materials:

> As a result of our buying local raw materials to ensure we meet 50% content we are forced to manage a significantly greater number of raw material items. Best illustrated in the colour based jacket linings where we must buy all the colours we require twice - one from our preferred (cheaper and better) quality and again from the locally sourced option. (sub. 17, p. 1)

In essence, some products are being designed for the rules, rather than for the market — that is, without the RVC requirement, some firms would buy different inputs, make different products and compete in different parts of the market.

16 This example abstracts from the possible application of the 2 percentage points tolerance margin.

*The CER content threshold of 50 per cent penalises the achievement of productivity gains by some firms. It can constrain firms' marketing options and adversely affect their competitiveness in other markets. Factors outside firms' control — such as exchange rate fluctuations — can make this rule difficult to satisfy.*

## Concerns about the treatment of particular expenses

The legislation/regulations in both countries provide information about the criteria for determining preference eligibility and prescribe what can be included in allowable expenditure on materials, labour and overheads (box 5.5). The regulations also give examples of expenditure items that cannot be included. This is supported by extensive guidance material issued by the Customs agencies in both countries.

Box 5.5 **Materials, labour and overheads counted towards origin**

In the determination of origin, expenditure on materials, labour and overheads contribute to the factory cost (and qualifying expenditure) of the good.

Expenditure on materials includes all costs directly attributable to the acquisition of the material, including the purchase price and freight costs associated with transporting the material to the factory. All materials used in the production of the good are counted toward the factory cost of the good.

Labour costs associated with the manufacture of the good may be counted toward factory cost (and qualifying expenditure). Labour costs may include:

- manufacturing wages and employee benefits;
- supervision and training;
- management of the process of manufacture; and
- handling and storage of goods within the factory.

Overhead costs associated with the manufacture of the good may also be counted toward factory cost (and qualifying expenditure). Overhead costs may include:

- costs associated with the upkeep of the factory such as insurance, rent and leasing, mortgage interest, depreciation of buildings, maintenance, repair, rates and taxes;
- costs associated with the purchase and upkeep of machinery and equipment such as interest payments, depreciation, maintenance and repair and leasing costs;
- research, development, design and engineering costs;
- expenditure on energy, fuel, water, lighting, lubricants, rags and other materials and supplies not directly incorporated in manufactured goods; and
- miscellaneous costs such as factory security, testing and quality control, insurance of goods and materials, cleaning services, training services, safety and protective clothing, and the disposal of non recyclable waste.

Nevertheless, labour and overhead costs can only be included in factory costs and qualifying expenditure to the extent that they:

- are incurred by the manufacturer of the goods;
- relate directly or indirectly (and wholly or partly) to the manufacture of the goods;
- can reasonably be allocated to the production of the goods; and
- are not specifically excluded under the regulations.

Costs associated with the general expense of doing business such as administrative, executive, advertising, marketing, accounting, communication (such as telephone costs) and travel costs are specifically excluded from forming part of factory costs and qualifying expenditure. In addition, costs incurred after the completion of manufacture (such as shipping costs) are also excluded.

*Sources:* Australian Customs (2003a,c), New Zealand Customs (2003b).

The rules allow only expenses that are directly or indirectly related to the manufacture of the goods for which preference is claimed. Some firms told the Commission that the list of inclusions is too restrictive and argued for a broader range of expenses to be allowed. Cambridge Clothing, for example, submitted:

> The measure of qualifying manufacturing cost allowed by the ACS excludes some elements we consider must be included to account properly for the costs of running the business. Examples of these include overseas travel by manufacturing people (necessary for the research and development to keep up with international best practice), telephones and stationery. (sub. 19, p. 4)

Fisher & Paykel had similar concerns. In its view:

> … exclusion of these sorts of costs shows how unrealistic the rules can be … they don't reflect the reality of modern firms/business environment. (pers. com.)

Hot Clothing recommended that:

> Overheads, both Direct and Indirect where necessarily incurred to produce the product in Australia must be an allowable cost. (sub. 18, p. 4)

Some participants also suggested that local costs incurred after the completion of manufacture should be allowable. Such costs could include a manufacturer's profit margin and the costs of transportation to the export terminal or port. Cambridge Clothing (pers. com.) considered that the very substantial storage costs it incurs for completed suits should also be an allowable expense.

### *Lack of clarity*

Notwithstanding the prescriptive detail in the legislation/regulations and the availability of guidance material, a number of participants are confused and uncertain about the treatment of various expenses. Hart Manufacturing (sub. 1, p. 3) suggested that there is scope for the rules to be 'clarified and made more simplistic in their format' and Country Road described the rules applying to the treatment of various costs as 'complex':

> This complexity is compounded by different interpretations of eligibility for various components on both sides of the Tasman. (sub. 22, p. 6)

The general concern was expressed that the rationale or basis for exclusion of some costs is not always clear — why should one type of expense be allowable and another, seemingly equally consistent with the apparent intent of the CER Agreement, be disallowed. Cue Design suggested that:

> … historic justification, reasoning and intent must be easily accessible to affected parties. While these are not law, they would clearly show the background and trail of an issue and could be used as support to an argument. (sub. 6, p. 3)

### *Overheads*

Other specific concerns raised about the exclusion or particular treatment of certain overhead expenses and margins are briefly outlined below.

- The exclusion of the selling and profit margins of the final manufacturer — Cambridge Clothing, for example, commented on:

  … the inequity of the manufacturing exporter being able to include factory cost only, whereas the raw materials in the calculation all contain administration, selling and profit margins. (sub. 19, p. 5)

  The exclusion of margins is a particular concern where the final process is outsourced. Hot Clothing, for instance, suggested that:

  … this so called manufacturers 'profit' should be a qualifying cost to us the principal. The full cost of the contract makers invoice to us should qualify as local cost. (sub. 18, p. 4)

- Again, when the final process is outsourced, research, development and design expenses incurred by the principal manufacturer may not be treated as a qualifying expense under the 'last place of manufacture' rule.

- Certain interest costs may form part of qualifying expenditure, but this favours firms that carry considerable debt. The New Zealand Government agencies pointed out that low-geared companies '… which fund investment from internal funds are unable to impute a cost of capital as a qualifying expense …' (sub. 20, p. 9)

- Fisher & Paykel also suggested that there should be an allowance for dividends: 'Dividends represent a cost of capital and should be recognised in qualifying content.' (sub. 23, p. 5)

On the other hand, the Harold Boot Company argued that certain types of currently allowed expenditure, should not count as allowable expenditure on overheads.

> We see no valid reason for the list of allowable expenditure to include items 'without regard to whether these items originate within the territory of a Member State'. We refer to the types of items listing in Article 3 at (c) Dies, moulds, tooling…, (g) Leasing of plant and equipment…, and (h) Materials and supplies not directly incorporated in the manufactured goods (eg energy, fuel, water, lighting, lubricants, etc). … Similarly, the items at (k) Subscriptions to standards institutions, etc. seems an unnecessary inclusion. (sub. 11, p. 2)

### *Intermediate materials*

In relation to material expenses, the concern was expressed that the local content valuation of intermediate materials (allowable materials expenditure) depends on whether those materials are produced in-house, purchased in an arm's-length transaction at normal value or supplied at less or more than the normal value either in a non arm's-length transaction or in a contract/commission arrangement. In the 'less or more than normal market value' cases, the materials value can be determined by Customs (section 5.3).

When intermediate materials are bought in at normal value, the full value of the materials (based on the invoiced price) — including overheads associated with their manufacture, transport costs and profit margins — can be counted towards qualifying expenditure. On the other hand, when materials are produced in-house, an equivalent profit on materials cannot be counted in qualifying expenses. DITR submitted:

> If the factory buys in the materials needed to produce a good, then the area content calculation will take account of all capital costs (including profit on equity) involved in local production of those bought-in components. However, if the manufacturer produces a large proportion of its materials in-house, then the profit element in cost of capital will be disregarded — leading to a lower percentage outcome (if all else is equal). (sub. 16, p. 3)

## 5.5 Compliance and enforcement

Administration by Customs of CER RoO relies on self-assessment by importers, supplemented by some compliance audits. This section outlines concerns related to the efficacy and appropriateness of current enforcement strategies. Compliance and administration *costs* are discussed in chapter 6.

A number of participants suggested that there is a significant non-compliance problem with the RoO. PACIA, for instance, submitted that transhipment and manipulation of the rules of origin 'is the most immediate problem facing the Australian plastics and chemicals industries' (sub. 15, p. 8). It presented the following scenario as an example of transhipment:

> … a producer imports a product largely assembled in a third country and makes minor adjustments to it ahead of claiming 50% factory cost. In most cases companies must manipulate the allowable aspects of expenditure to meet the domestic content rule. As a result the product avoids the Australian or New Zealand non-preferential tariff and enters duty free through New Zealand or Australia into the other market. (sub. 15, p. 6)

PACIA further indicated that:

> The ability for companies to manipulate the criteria of the '50% rule' stems from the numerous definitional problems and lack of strict adherence to the rules. (p. 6)

The Distilled Spirits Industry Council of Australia agreed that there 'is a significant non-compliance problem with the RoO'. It said that to verify origin properly would require considerable review of the transactions occurring within New Zealand bottling plants and that, in cases where spirits are sold on an 'under-bond' basis, tracking of the goods by Customs is required. In its view, 'Customs may not be appropriately resourced for these enforcement activities' (sub. 39, pp. 3–4).

New Zealand Customs provided information to the Commission on unlawful manipulation of calculations, specifically in relation to outsourced production processes:

> The rules … are often subject to fraudulent activity such as sham "back to back" arrangements [where the price of the work or sub-componentry is inflated but refunded post the initial transaction] between manufacturers and contractors to those manufacturers. (sub. 21, p. 2)

Some participants suggested that, to the extent that there is non-compliance, this may be due to insufficient monitoring and audit activity. For example, the TFIA submitted that the experience of many TCF companies suggests that:

> … in the face of limited resources for Customs in either member country, the monitoring of preferential goods is more often than not an autonomous exercise. Insufficient resources and backing to identify and penalise exporters and importers who breach these rules allows manipulation of costs and values to occur to the detriment of the domestic economy and the agreement more generally. (sub. 12, p. 8)

PACIA (sub. 15, p. 8) also described monitoring by Customs as 'largely autonomous' and emphasised the importance of adequate monitoring, policing and enforcement of the rules. It suggested that the nature and complexity of chemicals and plastics processes make it difficult to attribute costs and that this increases the potential for both deliberate and accidental errors in calculation of local content. Such complexity also makes it difficult for Customs to detect errors, even where rigorous checking is undertaken.[17]

Indeed, while the costs of being found to be non-compliant can be high for the firm concerned, a low level of compliance checking and audit activity by Customs can reduce the incentive for some firms to ensure strict adherence with the rules. Even where firms are not deliberately manipulating calculations, there is little likelihood that errors will be detected and feedback provided to enable corrective actions to be taken. The New Zealand Government agencies suggested:

> Anecdotal evidence leads to the assumption that an increasing proportion of businesses are at risk of losing their tariff preference, or are trading on the basis of the odds being in their favour that they will not be subject to Customs investigation. (sub. 20, p. 11)

Australian Customs indicated that 0.2 per cent of all tariff entries were audited for, among other things, origin status. However, the data do not indicate how many of the tariff entries originated from New Zealand, and hence represent CER trade.[18] However, as Customs

[17] Under the Australian legislation and New Zealand regulations, where the CEO is satisfied that materials have been added or attached to the goods solely for the purpose of artificially raising the qualifying area content of the goods, expenditure on those materials may be excluded from the calculation of factory cost — Section 153E (4) of the *Customs Act 1901* (Australia) and New Zealand *Customs and Excise Regulations 1996*, Regulation 38 (3).

[18] Australian Customs advised that just under 15 000 entry lines (or 0.2 per cent of all entries) were audited for, among other things, origin status. However, Customs was unable to indicate the

advised that, in 2002-03, no goods entering Australia from New Zealand were found to have failed to comply with the origin requirements, the overall level of auditing of CER origin would also appear to be quite low.

New Zealand Customs provided the following information on its compliance monitoring:

> Over the year ending June 2003, 490 imports from Australia claiming CER-preference were examined. Of these 490 examinations, 145 resulted in preferential entry being declined. This activity comprised a mix of both the physical examination of the goods at the time of entry and under the Service's post-entry audit regime. (sub. 25, p. 2)

The Commission estimates that the 490 examinations represents around 0.2 per cent of all goods claiming preference under the CER.[19] In addition, the figures supplied by New Zealand Customs suggest a relatively high level of non-compliance — at least in some areas. That is, where examinations were conducted, nearly 30 per cent resulted in preferential entry being denied.[20]

Broadly, Customs in both countries use risk management techniques, industry complaints mechanisms and institutional knowledge to provide the basis for their program of audit activities. New Zealand Customs advised that it identifies and audits 'importers/industries representing the most significant risk to government's expected outcomes' (sub. 25, p. 3). The Commission has not received sufficient information to determine whether or not serious non-compliance problems characterise CER RoO more generally.

Some further information on Customs' auditing activities is contained in chapter 6.

## 5.6 Determined manufactured raw materials

Some manufacturing processes in Australia and New Zealand incorporate inputs of materials that are not produced in either country. A number of participants are concerned

proportion of these audits that were for goods entering from New Zealand. If it was assumed that the number of preference audits is proportional to the share of total entries, this would imply that around 450 lines (out of an estimated 195 000 lines) were audited for preference-claim goods from New Zealand.

19 New Zealand Customs (sub. 25, p. 3) reported that, in 2002-03, the number of import entry lines originating from Australia totalled 611 585. The Commission has independently estimated, for 2000-01 (from trade data supplied by the ABS), that approximately 35 per cent of total New Zealand imports from Australia claimed preference (chapter 2). Applying this percentage to the 2002-03 total import figure would suggest around 214 000 import lines on which preference was claimed. The 490 examinations would then represent approximately 0.2 per cent of goods claiming preference.

20 To the extent that compliance checking activity is targeted (at goods where the risk of non-compliance is higher), the 30 per cent figure would not necessarily be representative of the overall level of non-compliance.

that the incorporation of such materials is acting as a barrier to the granting of preference for finished goods and some suggested that these materials should not count against CER area content.

The Australia–New Zealand Business Council said:

> The council sees no logic in penalising the use of manufactured raw materials in circumstances where the materials concerned are manufactured in neither Australia or New Zealand. … The existence of an MFN tariff rate of Free in the Australian or New Zealand tariff signifies the absence of manufacture in the country concerned. Where both countries have implemented such a zero tariff, then we urge that, for as long as a content requirement exists, such products be excluded from the calculation of 'imported' or 'non regional' content. (sub. 40, p. 4)

The Determined Manufactured Raw Materials (DMRM) system provides for certain materials of third country origin, which are not manufactured in either Australia or New Zealand, to be determined as 'manufactured raw materials' and, in narrowly defined circumstances, to be treated as being the origin of either Australia or New Zealand. While the procedures for granting of a DMRM are not identical for each country, the core criteria are similar:

- a substantive duty free tariff rate or duty concession which may be a Tariff concession in either country; and
- no objection being raised by either an Australian or New Zealand manufacturer on the basis that the material, or a substitutable/suitable alternative material, is manufactured by them (New Zealand Customs 2003d).

Materials that have been determined can only be treated as 'CER materials' when they are used in finished goods that are otherwise *wholly manufactured* in either Australia or New Zealand. In order to obtain *wholly manufactured* status, the finished goods generally must achieve 100 per cent CER content (that is, no material or process from a third country forms part of the finished good).[21] Finished goods *wholly manufactured* in either country from CER materials and/or from DMRM enter duty free.

However, the same DMRMs used in goods *partly manufactured* (that is, combined with other non-CER imported content) in Australia are *not* treated as allowable expenditure in factory cost calculations — they are treated as non-qualifying imported content.

Some suggest that the current system imposes significant constraints on the operation of certain firms. Submissions recommended that consideration be given to treating a wider range of imported materials, not manufactured in Australia or New Zealand, as CER

[21] However, a 3 per cent tolerance margin is applied to allow for minor constituents which are the manufacture of countries other than Australia or New Zealand. Thus, in effect, wholly manufactured is administered as being 97 per cent CER content.

content — including in factory cost calculations for *partly manufactured* goods. Cue Design, for example, stated that:

> Some additional consideration should be given to industries such as the clothing industry, where locally manufactured materials are not available (in either Australia or New Zealand). In the case of fabrics imported into Australia, a number of fabrics are duty free in their own right. In addition, some cotton and all underweight woven fabrics may be imported free of duty under a tariff concession order, supporting the case that these fabrics are not manufactured in Australia. Perhaps this could be taken into account when assessing qualifying content. (sub. 6, p. 3)

Likewise, Country Road suggested that:

> [The DMRM] concept could be extended to include any manufactured raw material that can enter the commerce of both countries at a duty free or minimum (concessional) rate. Under this arrangement "DMRM's" would be defined as goods that enter both Australia and New Zealand duty free under their substantive duty rate or under a Tariff Concession, that is; a duty free rate presumes that there is no local manufacture to protect therefore there can be no construed disadvantage to either country if "DMRM's" are able to be used to calculate area content. (sub. 22, p. 8)

On the other hand, some suggested that the administration of the DMRM system is too liberal. The TFIA, for instance (sub. 12, p. 5), expressed concern about the risk that a DMRM might be granted to a material for which there *is* production in Australia. In particular, the concern related to materials with a substantive duty free tariff rate or with concessional duties applied via a policy by-law. The submission noted that several policy by-laws allow for concessional (duty free) entry of imported products, even where equivalent items are produced in Australia. The TFIA considered that the consultation process currently followed may not allow local manufacturers sufficient time to object.

## 5.7 Differences in duty on inputs

Some participants expressed concern that producers in one country (typically New Zealand) have greater access to inputs which are free of tariffs — either substantively, or through other government policies — and therefore already have a competitive edge in the other country's (typically Australia's) domestic market. Some argued that this competitive advantage would be magnified by any liberalisation of the RoO and should be taken into account in decisions concerning the design of origin rules.

By way of example, PACIA said that imports of linear alkyl benzene into Australia attract a 3 per cent revenue tariff but are duty free into New Zealand, with the result that the manufacture of final goods using this input faces different cost structures in the two countries. This, it was argued, affects their relative competitiveness as New Zealand firms can sell at lower prices in the Australian market (sub. 15, p. 6). To avoid such uneven

impacts, PACIA advocated harmonisation of the Australian and New Zealand tariff schedules (sub. 15, p. 7).

Similarly, the TFIA expressed concern that while, for example, fabric for the manufacture of suits enters Australia at a tariff of 15 per cent, it is available to New Zealand producers duty free, either directly or through duty drawback[22] on the exported finished suit. This provides a cost advantage to the New Zealand manufacturer:

> … allowing the suit to be sold into Australia at a significantly lower wholesale price. This in turn places price pressure on Australian manufacturers and leads to a loss of market share. (sub. 12, p. 5)

DITR observed that different tariffs on inputs can provide commercial advantage:

> If the imported inputs for a product are exposed to a very low (or zero) rate of duty in one of the jurisdictions and are exposed to a significant duty in the other, then a commercial advantage can be available to the producer paying a low or zero duty on inputs which is not related to that producer's relative efficiency. (sub. 28, p. 2)

It also noted that:

> A distortion can be introduced under a free trade agreement where there are differences between members' tariffs on the inputs to goods that are traded at preferential rates. This distortion will be greater where the rule of origin grants preference with a low value added from the FTA area. (sub. 28, p. 6).

DITR observed that where such differences exist, as they do between Australia and New Zealand, and with third countries, there could be cases where production could be inefficiently diverted from lower-cost domestic firms to higher-cost New Zealand firms. In its view, this would increase competition faced by Australian import competing firms and yield a welfare loss to Australia. Accordingly, it argued for maintenance of the current RoO, as:

> … regional value criteria that set a significant minimum on the amount of area value added can serve to limit the trade distortion that occurs. (sub. 16, p. 5)

At the same time, DITR noted that:

> By and large the distortionary effects are only significant now in the textile, clothing and footwear sector because that is the only sector with high input tariffs and with significant production capability in both economies. (sub. 28, p. 2)

The TFIA concurred with DITR's analysis on the ground that:

> … the producer in the country that has the lower tariff or access to duty drawback and a larger target export market is at an advantage compared to the producer in the domestic market. (sub. 34, p. 8)

22 Duty drawback arrangements provide for the reimbursement of duty charged on imported inputs when the final product is exported.

While these concerns highlight the importance of different tariffs on inputs and duty drawback, they focus only on the Australian domestic market and on one possible outcome. Account also needs to be taken of the scope for greater access for Australian exports to the domestic market of New Zealand, and for production and exporting more broadly.

## Duty drawback

Because duty drawback allows exporters to claim back the duty payable on inputs incorporated into goods produced for export, but not those sold in the domestic market, the cost structure of the same goods produced for the home market and the PTA partner country market — and other export markets — will differ.

When both countries allow duty drawback — as under CER — goods exported to the other member country's domestic market will receive an input price advantage (equal to the tariffs on inputs) over goods produced domestically. That is, Australian exports will receive an advantage in the New Zealand market, and New Zealand exports will receive an advantage in the Australian market. DITR said:

> … duty drawback enables importers from a CER partner trading into the other partner to receive net effective assistance relative to domestic producers. The problem is especially apparent in the Australian and New Zealand clothing sectors where there are substantial tariffs on both inputs and final products. (sub. 16, p. 4)

It provided hypothetical illustrations of how duty drawback can lead to outcomes where the lower-cost producer is disadvantaged under CER in specific cases (sub. 29). The analysis highlights the importance of tariffs on inputs and the operation of drawback. However, the outcomes are sensitive to the assumptions made and examples based on particular combinations of local and imported costs, input tariffs and drawback cannot provide a unique conclusion about efficiency effects (box 5.6).

Moreover, the impact on competition in the domestic market is only part of the story. The allowance of duty drawback has a number of other consequences for Australian and New Zealand firms in their export activity generally.

- Australian and New Zealand exporters have access to imported inputs at world prices. They therefore avoid the distortions which tariffs on inputs impose. Without duty drawback, the cost advantage may well accrue to the exporter in the country with the lower input tariffs, not the exporter in the country with lower input costs.
- Australian and New Zealand exporters have more options to vary their input mix and improve their international competitiveness. Protection of higher cost domestic input suppliers is thereby reduced.

- Australian and New Zealand exporters also have a competitive advantage over third country exporters that are required to pay duty on imported inputs.

The allowance of drawback between CER partners has a number of additional consequences for exporting.

- Exporters in the CER member country with the higher tariffs on inputs (typically Australia) are better able to compete with producers in the domestic market of other CER country (typically New Zealand).
- Australian and New Zealand firms that export to the other CER country are placed on the same competitive footing as third country suppliers that also have access to duty free inputs (through, for example, duty drawback or zero MFN tariffs). By not disadvantaging Australian and New Zealand firms against suppliers from third countries, duty drawback conforms with the goals of the CER.

Overall, with duty drawback, trade outcomes will be determined more by the underlying cost efficiency of exporters than by tariffs on their intermediate inputs. In 1996-97, the imported component of production in Australian manufacturing was typically below 20 per cent. It was no higher than 28 per cent in any relevant sector. Allowance of drawback in the CER is likely to result in additional trans-Tasman trade as producers take advantage of the tariff reduction on inputs imported from third countries.

These conceptual arguments aside, the practical importance of duty drawback has declined significantly as tariffs have fallen. For example, the cost impost in 1989-90

## Box 5.6 **Duty drawback and CER trade: some hypothetical examples**

DITR constructed examples illustrating some adverse implications of duty drawback. The examples (in the table below) refer to a hypothetical producer in home country B competing with a hypothetical exporter in partner country A. Scenario 1 illustrates that:

> The producer in A clearly has an advantage over the producer in B in selling the good in B's market. In this situation there is no apparent difference in the efficiency of the producers. (sub. 28, p. 6)

Even if goods from country A cost more to produce (scenario 2), they still may be able to compete in country B at the same price as goods produced in country B because of the cost saving from duty drawback, but with adverse competitive implications for B:

> … as much as $115 of B's GDP might be paid for the good produced in A when the same good could be produced at home for the expenditure of only $110 of B's resources. There is a clear net loss for B through the diversion from domestic supply to supply from the FTA partner. (sub. 28, p. 6)

| | *Goods exported from A to B* | | | |
|---|---|---|---|---|
| | *Scenario I* | | *Scenario 2* | |
| | *Costs in A* | *Costs in B* | *Costs in A* | *Costs in B* |
| Imported inputs | 50 | 50 | 50 | 50 |
| Duty at 10% | Drawback | 5 | Drawback | 5 |
| Local factory cost | 50 | 50 | 55 | 50 |
| Other costs & profits | 10 | 10 | 10 | 10 |
| Free-into-store price | 110 | 115 | 115 | 115 |

However, the proof by example is incomplete. Other examples can be offered where drawback does not result in increased resource costs. For example, in scenario 1, if local factory costs in country A were $45 rather than $50, producers in country A would be competitive in country B, with or without duty drawback. And, the resource cost of the product to home-country B would be $105 (or $110 without drawback).

More importantly, allowing drawback can lower costs. If A's local factory costs were $47 instead of $50 and A paid duty on imported inputs, *while* B had no duty on imported inputs, A would be the more efficient producer — with a resource cost of $107 compared with $110 in B. However, A could not compete in country B without drawback. In this case, allowing drawback would overcome the intermediate input problem resulting from tariff rate differences.

of tariffs on imported inputs[23] was about 8 per cent for Australian manufactures and 4 per cent for New Zealand manufactures. By 2001-02, this impost had declined to under 3 per cent and around 1 per cent, respectively. Scheduled tariff reductions will further reduce the cost impost. Duty forgone in Australia under drawback amounted to about A$120 million

[23] This is the nominal rate of assistance on inputs.

or 0.08 per cent of the value of Australia's imports in 2001-02. An additional A$155 million was forgone under the related *Tradex* scheme.

For Australian clothing manufacturers (the focus of concerns by TFIA and DITR), the cost impost of tariffs has declined from 29 per cent in 1990 to just over 5 per cent in 2001-02. For the New Zealand industry the cost impost is estimated to have declined from around 11 per cent to 6 per cent over the same period. Given these low and declining cost imposts, duty drawback can have only a modest impact on prices at the retail level. For example, removal of the total cost of tariffs on inputs in New Zealand (ie 6 per cent), on reasonable assumptions, could lower the cost of a good to consumers in Australia by less than 1 per cent (equivalent to less than $10 on a $1000 men's suit). Such a reduction could have implications for competitive pressure on some manufacturers.

But even if duty drawback was significant and considered to be causing difficulties in some areas, the more efficient approach would be to review and perhaps change the present drawback provisions. Such a review would need to consider that, while the existence of duty drawback generates some anomalies, its removal would generate other anomalies. Indeed, DITR did not advocate removal of duty drawback because:

> … with both countries developing [PTAs] with a range of other partners, disallowing duty drawback would not, of itself, guarantee neutrality in the treatment of inputs even if MFN rates on the final products are equal. (sub. 28, p. 2)

In summary, while allowing drawback has implications for Australian and New Zealand producers, concerns about some of its possible effects should not influence the design of CER RoO, particularly given current tariff levels which are historically low. More specifically, the concerns do not support designing RoO in such a way as to restrict firms' options to vary their input mix to take advantage of lower tariffs on intermediate inputs and duty drawback.

## How much significance should be accorded to different input costs?

Different tariffs on material inputs and the operation of duty drawback are only one of many sources of difference in the costs and conditions of production. For example, PACIA said that, were raw materials to be dumped into New Zealand, producers of plastics and chemicals in that country could produce final goods using lower-priced inputs than are available to Australian firms (sub. 15, p. 7).[24]

[24] Australia and New Zealand gave up their right to take anti-dumping action against one another for goods which enter under CER preference. Nevertheless, as New Zealand has a smaller chemicals industry, it is often not possible (or indeed desirable) for New Zealand firms to take action against non-CER countries supplying low-priced imports when dumping is suspected. This would be particularly so because there may be no competing New Zealand production that could suffer damage as a result of any (alleged) dumping (PACIA, sub. 15, p. 7).

These measures represent only a small part of the differences in input costs between Australia and New Zealand (and between firms within each country). Natural resource endowments and costs, the availability and cost of transport and infrastructure, and the nature, cost and skill levels of the domestic labour force all may differ. Differences also arise because of the specific requirements of each country's taxation and regulatory regimes, and the individual attributes of managers and employees. In Australia, State and Territory government taxation and subsidy programs may also penalise or advantage firms. In the case of TCF, Australian producers are advantaged relative to New Zealand producers by grants available under the Government's post-2005 assistance package. The list of influences on input costs is endless.

Given the maturity of the CER, current and projected tariffs and the recent initiative to develop a single trans-Tasman market, the Commission does not agree that CER origin rules should be tailored to offset differences in input costs arising from tariff differences and duty drawback. This would amount to introducing a second intervention — with all of its own adverse impacts on, for example, firm organisation and productivity — to address the effects of other trade policies. As some participants pointed out, the best approach would be to remove the source of the original distortion itself. Of particular concern to some Australian participants is the concessional tariff of 3 per cent under the Tariff Concession System and policy by-laws. In its Review of Australia's Tariff Arrangements (PC 2000, p. xxv), the Commission recommended that concessional tariffs and general tariff rates be reduced to 'Free'. These recommendation were not adopted by the Government, because of revenue considerations.

FINDING

*It would not be appropriate to design rules of origin in such a way as to compensate for differences between input costs in Australia and New Zealand, irrespective of the cause of such differences.*

## Officials' group proposal for change to the treatment of intermediate inputs

Australia's DFAT said that, in line with the Trade Ministers' Communiqué of 28 August 2003, the CER officials' group has developed a proposal to allow a proportion of imported materials to be 'appropriately disregarded' from the calculation of the total cost of the finished good for the purpose of determining local content under the CER (box 5.7). DFAT advised that:

> … as part of a package of ROO reforms, New Zealand has requested a change in the treatment of 'intermediate' goods, that are not produced in either Australia or New Zealand, for the purpose of calculating local content under ANZCERTA. Changes

> under consideration would disregard (up to a limit of 33 per cent) the value of such imported materials. (sub. 37, p. 4)

Few participants commented on this matter. DFAT advised that:

> Australian Government officials have discussed the proposal with several industry associations who subsequently sought feedback on the proposal from their members. The Australian Industry Group was supportive of the proposal, particularly as the proposal includes built in protections with the 'not produced in either country' criterion and cap. The Council of Textiles and Fashion Industries of Australia, however, does not support the change. (sub. 37, p. 3)

Fisher & Paykel argued that where goods used as inputs into production are not produced in either country, their cost should be removed from the calculation of factory or works cost to avoid penalising manufacturers who are forced to import componentry which is not available from Australian or New Zealand manufacturers (sub. 36, p. 3). It argued for:

> … a public notification system, which can be relied upon by importers and manufacturers, and which confers automatic qualification. (sub. 47, p. 1)

Cambridge Clothing also saw merit in the officials' group proposal, and argued that the 33 per cent cap be applied against the total factory cost and not on a per item basis.

The New Zealand Government agencies advised that:

> … the motivation … is to give greater flexibility to businesses on both sides of the Tasman using inputs not produced in either Australia or New Zealand. … a cap, set at 33 per cent of the overall ex factory cost of a product, would apply to ensure the provision did not undermine the requirement for substantial transformation. … This proposal, if implemented as an interim measure prior to more fundamental reform of the RoO, could offer some early benefits to exporters on both sides of the Tasman by allowing greater scope for the use of intermediate inputs of foreign origin without putting at risk eligibility for preference under CER. (sub. 46, p. 2)

Box 5.7 **Intermediate inputs: officials' group proposal**

The proposal is as follows:

- Only materials not produced in either country would qualify.
- Coverage by the Tariff Concession Orders (TCOs) in both countries would represent an appropriate proxy for goods not produced in each country.[25]
- As such, materials on the TCO lists of both countries would meet the eligibility criterion and automatically qualify under the new provision.
- Materials approved under the determined manufactured raw materials (DMRM) regime also would qualify automatically for treatment under the new provision.
- Where TCOs are not available, the process for determining whether a material is not produced in either Australia or New Zealand should be similar to the process for seeking a TCO.[26] Materials approved in this manner would be published on a public schedule.
- A 33 per cent cap (of the total factory cost) would apply to the use of the new provision to ensure that there is no abuse of the new arrangements.
- Use of the provision would be voluntary.

*Source:* DFAT, sub. 37.

The officials' group proposal would liberalise the RoO in some specific circumstances, and this would be a benefit to some firms engaged in CER trade. But it would do so only in a piecemeal way. The proposal essentially constitutes a 'conditional waiver' of the 50 per cent RVC threshold for firms with significant imported inputs where there is no CER equivalent production. It would amount to minor tailoring of the rules, providing a degree of liberalisation to overcome some of the acknowledged limitations of the current RoO while having minimal competitive impact on, for example, domestic suppliers of inputs. The proposal is essentially a variant of broader arguments to design the RoO in a manner which takes account of differences in inputs costs between the two CER countries (in this

25 A TCO allows duty free entry of a good, irrespective of the MFN tariff, where there is no local production of that good. New Zealand and Australia have somewhat different arrangements for TCOs. Broadly, in New Zealand, once a TCO is issued, the MFN rate drops to zero and remains there. In Australia, the TCO may be revoked if a local producer later sets up production of the good concerned. In that case, the MFN rate would apply at the substantive level.

26 Article 14 of the CER currently provides remedies for situations when, for example, producers or manufacturers of goods in one country obtain intermediate inputs at lower prices or on other more favourable terms and conditions than are available to the producers or manufactures of like goods in the territory of the other Member State. However, the Article has not been widely used and there have been no formal applications to Australian Customs since 1994. Declining tariff rates and the cost of mounting a case are likely reasons for the low use of this provision.

case, by changing the RVC formula). As such, it is open to some of the same objections as apply to the RVC rule.

## 5.8 Recent developments

Since the release of the interim report, the Ministers have agreed to three significant changes: to adopt the 'principal manufacturer' concept; to change the treatment of intermediate inputs which neither country produces; and to establish a Joint Customs Committee. This section briefly outlines the first change. The second was discussed earlier in this chapter.

In January 2004, New Zealand amended its *Customs and Excise Regulations 1996* to allow the inclusion of costs incurred by outsourced or contract work. The amendments mean that eligible costs are now calculated for the 'principal manufacturer' rather than the factory which performed the last process of manufacture. This effectively solves the 'outsourcing' problem, discussed in section 5.3, for goods exported from Australia to New Zealand.

New Zealand Customs stated:

> The amended regulations now enable overhead costs, such as design and pattern making, when supplied free of charge by the principal manufacturer to a contract manufacturer, to contribute towards qualifying content.
>
> The Regulations now refer to "factory or works cost" and "qualifying materials" as costs incurred by the "principal manufacturer" without significantly altering the range of elements that may contribute towards qualifying content. (New Zealand Customs 2004, p. 1)

The amended New Zealand definitions of 'principal manufacturer' and 'factory or works cost' are set out in box 5.8.

Australia has committed to implementing similar changes. Australian Customs noted:

> New Zealand has addressed the issue of outsourcing through the Customs and Excise Amendment Regulations 2003 … Australia intends to introduce similar amendments to its customs legislation. (sub. 32, pp. 1–2)

Box 5.8 **Principal manufacturer and factory cost**

*Principal manufacturer*

"Principal manufacturer", in relation to any goods, means –

a) a person in Australia who performs the last process in the manufacture of goods in Australia; or

b) if the person referred to in paragraph (a) performs the last process in the manufacture of goods on behalf of another person in Australia or New Zealand, that other person.

*Factory or works cost*

"Factory or works cost", in relation to any goods, means any expenditure –

a) that either –

(i) is incurred directly by the principal manufacturer in the production of the goods; or

(ii) is incurred indirectly by the principal manufacturer and can reasonably by allocated to the production of the goods; and

b) is determined in accordance with regulation 34.

*Source: Customs and Excise Regulations 1996 (New Zealand)*, Reg. 32.

## 5.9 Concluding comments

It is clear from the evidence presented in this chapter that there are significant problems with the design, implementation and enforcement of the CER RoO. Although the basic criteria are simple, their implementation involves some complexities and has only recently started to adapt to modern business practices, including the growing trend toward specialisation and outsourcing. The inflexibility of the rules is denying preferential entry to goods that contain substantial regional content.

Problems such as inconsistent treatment (that favours some activities or business models relative to others), instability and uncertainty (especially due to the sensitivity of calculations to exchange rate movements) and efficiency disincentives are having a perverse influence on production and investment decisions in both Australia and New Zealand. While some of these problems, particularly the inconsistent and inequitable treatment of outsourcing, have been recognised by the Governments of both countries and are being addressed, some reflect fundamental design problems that also need to be addressed.

However, some concerns raised by participants — for example, in relation to MFN tariff differentials between Australia and New Zealand and the operation of duty drawback and anti-dumping laws — are not matters that are efficiently addressed by the design of the

RoO. Moreover, because tariff reductions in both countries have significantly reduced the impact of these measures, the potential for the use of RoO as an instrument to offset the liberalising effect of these policies has also diminished.

Many aspects of the operation, design and implementation of the RoO remain inconsistent with the principles outlined by the Australian and New Zealand Trade Ministers in their recent Joint Ministerial Statement on Rules of Origin. They are also inconsistent with recently announced initiatives by Ministers of both Governments to further integrate the Australian and New Zealand markets.

The Commission considers design principles and other issues relevant to the development of more effective RoO in chapter 7 and evaluates options for change to the RoO in chapter 8.

# 6 Compliance and administration costs

This chapter examines the scope of the compliance costs incurred by business (both manufacturers and importers) in calculating and proving origin for their goods, and the costs incurred by Customs in administering and enforcing the RoO. It also outlines the processes involved in trading goods under preference, including the determination and claiming of origin. The chapter concludes with some comments on the possible compliance and administration costs imposed by multiple RoO (under multiple PTAs).

## 6.1 Scope of compliance and administration costs

Compliance costs are those faced by a business or organisation in meeting obligations imposed upon them by regulation or legislation. In the context of this study, they are the costs incurred by business in proving that goods satisfy CER rules of origin. Administration costs are the costs incurred by government agencies (principally the Customs Services of Australia and New Zealand) in overseeing and enforcing the RoO.

Commonly, compliance costs are thought of as being the 'paperwork' or 'red tape' costs associated with filling out forms in order to satisfy Customs requirements. In addition to these costs, a number of other burdens may be associated with proving origin, including:

- the costs associated with determining what the origin requirements are;
- the day-to-day costs of determining origin for each product or shipment;
- the costs of implementing new systems or programs in order to prove origin; and
- the costs of maintaining records in order to be able to prove origin in the future (in the event of an audit).

Certain other costs borne by business as a consequence of the CER RoO are not considered to be 'compliance' costs for the purposes of the discussion in this chapter. These include costs associated with changing the production methods or input mixes to meet origin requirements. These, and other efficiency costs, are included in the discussion of economic effects of RoO in chapter 4.

In assessing compliance and administration costs, the Commission is concerned with the incremental or additional costs of proving origin. That is, the cost of activities that assist in

proving origin but would be undertaken in any case (for example, for internal review or taxation purposes) are *not* considered to be compliance costs.

To date, no comprehensive study of compliance costs imposed by RoO under the CER has been undertaken. Nevertheless, several studies of other agreements suggest that compliance costs associated with RoO can be significant. Evidence available to this study gives some indication of the possible imposts of CER RoO on firms engaged in trans-Tasman trade.

## Overseas studies

A number of studies have examined the compliance costs (of border formalities and paperwork) incurred by firms in the European Free Trade Area (EFTA) when exporting to the European Union (formerly the European Community).

- Holmes and Shephard (1983) estimated that compliance costs were between 1.5 per cent and 5.7 per cent of the value of the goods.
- Koskinen (1983, cited in Stephenson 1997) estimated that compliance costs were 2 to 3 per cent of the value of the finished products.
- Herin (1986) found that 25 per cent of goods that were eligible for preferential entry actually paid the MFN duties rather than being imported under preference. Herin attributed this behaviour largely to the costs involved in proving origin for the goods.
- Hoekman and Leidy (1993) noted that a significant number of EFTA firms decided that it was 'simpler and cheaper' to pay the MFN tariff (which averaged around 6 per cent for industrial goods) than to prove that the goods met the origin requirements.

More recent studies of the European Union's 'Everything but Arms' agreements (with a number of countries) suggest that RoO in general, and compliance costs in particular, impose significant barriers to trade. Brenton and Manchin (2002) and Brenton (2003) found that a significant number of imports that are eligible for duty free entry under these agreements actually enter under MFN provisions and pay tariffs. The authors attributed this result to a combination of the difficulty of satisfying the often complex RoO and the costs associated with proving that origin has been met (which may require the use of relatively expensive accounting and documentation procedures).

These studies highlight the compliance costs — ranging from between 1.5 per cent to around 6 per cent of the value of traded goods — associated with RoO in some agreements. However, CER RoO differ from RoO in these other agreements in a number of ways. In particular, the CER RoO have less onerous requirements for proving origin (ie the self assessment mechanism discussed below) and a different method of calculation of origin.

*Overseas research suggests that the annual costs of complying with RoO can range from 1.5 per cent to almost 6 per cent of the value of the products traded.*

## 6.2 Claiming preference — the process

### Calculating origin — what is required?

As outlined earlier, assessment of CER origin eligibility requires calculating the factory cost and qualifying expenditure (local content) of the preference claim good. Such calculations require the measurement of all of the costs that can be directly or indirectly attributed to the manufacture of the good (see chapter 5).

To keep track of these costs, detailed records must be kept of expenses and the goods to which these expenses are attributable. For some inputs, it may be relatively simple to identify the associated output. However, for other inputs (particularly labour costs and overheads) it may be very difficult to associate inputs with individual outputs.

Overall, the factory cost process for calculating origin can be far from straight forward. The schedules that outline the types of expenditure that can and cannot be counted toward factory cost are five pages long (Australian Customs 2003c). In addition, factories need to be able to demonstrate that the expense can be attributed to the particular export in question. In all, the Australian Customs Manual, which explains how the origin of goods (ie imports to Australia) is determined, runs to more than 50 pages (Australian Customs 2003c).

### Importing goods — how are they cleared?

Both Australia and New Zealand employ a self-assessment system for determining the origin of goods and their eligibility for preferential entry. Under this practice, the importer of the goods is responsible for checking that the goods meet origin requirements and claiming preference accordingly. That said, of necessity, it is usually the manufacturer of the goods who is best placed to prove origin and upon whom the bulk of the compliance costs ultimately fall.

For goods entering Australia, importers are expected to make ‘reasonable enquiries about preference entitlement’ with the manufacturer (Australian Customs 2003a). The importer may also provide a declaration from the manufacturer stating that the goods qualify for preferential entry. Such a declaration would usually provide the importer with some

immunity from the application of penalties if the goods are subsequently found not to conform with the origin requirements. In the majority of cases, the goods would then enter Australia without further verification of origin status.

For goods entering New Zealand, Customs formally requires that the importer has sufficient information on which to base a claim for preferential entry. This is usually satisfied by the inclusion of a declaration from the manufacturer stating that the good(s) meet the origin requirements**.**

## Auditing origin — how is it policed?

Both Australian and New Zealand Customs undertake audit activity aimed at ensuring compliance with the origin requirements of the CER. Australian Customs can audit goods (compliance monitoring) at any time after the goods have cleared Customs. New Zealand Customs can audit goods (require a claim to be verified) at the time the goods are imported or at any subsequent time.

The first step in undertaking an audit is to identify the goods on which preference has been claimed and the manufacturer of these goods. Customs will then undertake research to establish whether there are grounds for further action (Australian Customs 2003c). If there are grounds for further action, Customs will forward a questionnaire to the manufacturer seeking details on the goods, the manufacturing process, the inputs, the sources of the inputs and the labour and overheads involved in producing the goods (see box 6.1). If insufficient information is obtained from responses to the questionnaire, Customs will take further action, which may include more detailed requests to the manufacturer, an inspection of the goods in question and/or an inspection of the factory where the goods are manufactured.

Box 6.1 **Information sought by Australian Customs during an audit**

In order to determine whether a good originates within the CER area, Customs seeks detailed information about the manufacturer, aspects of the manufacturing process and of the goods in question. Initially, this information is sought by sending a questionnaire to the manufacturer. If this does not clarify origin, Customs may pursue other methods of gaining the information, such as more direct questioning or visiting the factory. In questioning the company, Customs seeks information on the following matters.

- The profile of the business and any links that the manufacturer has with the Australian importer.
- Details of the finished goods, materials used in their manufacture and the process of manufacture.
- The cost to the manufacturer of acquiring each material input (and the components of this cost — that is, invoice costs, freight costs, taxes etc) that can be allocated to the finished goods upon which preference is claimed.
- Information on the suppliers of materials for the goods in question, including the address and contact details for each supplier and information on the inputs used by each supplier, the source of these inputs (that is, local or imported materials) and the cost (to the supplier) of each input.
- For material inputs that are manufactured locally from a mixture of imported and local materials, the cost of the imported materials used in their manufacture. For imports into New Zealand, the full factory cost and qualifying expenditure of the input must be included.
- Detailed information on the labour costs associated with the goods in question. This may include a company organisation chart showing all work areas in the company, names of persons working in each area and the wages and salaries paid to each worker.
- Detailed information on the factory overheads associated with the goods in question, including an explanation of how actual costs of factory overheads were allocated to the good.

*Source:* Australian Customs (2003c).

When sufficient information is available, Customs will decide whether or not the good(s) in question qualify for preferential entry. Where goods have been imported under preference and are later found not to qualify, the importer of the goods will be responsible for paying any forgone duty. In addition, Customs may impose penalties upon the importer of the goods (though it has no powers to impose penalties upon a foreign manufacturer).

*Rules of origin complaints*

In addition to regular audits, Customs in both countries will also investigate complaints (which are usually made by competing manufacturers in the importing country) about the preference eligibility of imported products.

In 1995, Australia and New Zealand signed a protocol on Customs procedures which outlines the manner in which both countries' Customs Services deal with RoO complaints (Australian Customs 2003b, New Zealand Customs 2003c).

Initially, Customs undertakes a screening process to establish whether there is a *prima facie* case for further investigation.[1] In general, further steps taken to address the question of origin entitlement following complaints correspond to those undertaken during general audits (although Customs is obliged to undertake preference inquiries in response to a complaint within set time frames).

## 6.3 What costs does proving origin impose on business?

### What types of costs are likely to be incurred?

The procedures for proving that goods meet origin criteria place a number of responsibilities upon businesses seeking preferential entry for their goods. These responsibilities are likely to impose various compliance costs upon business, including:

- costs incurred in understanding how the RoO work (such as time spent searching for the rules, contacting Customs officials and understanding the factory cost method of determining origin);
- costs associated with determining whether the goods meet origin requirements (including time spent applying the RoO to the goods in question);
- costs of new processes or programs established to prove that goods meet origin requirements (such as time and expenditure spent developing new accounting practices or computer programs to track expenditure and establish origin);
- ongoing costs of checking that goods continue to meet the RoO (which are likely to depend on the frequency and rigour with which manufacturers check origin); and

[1] This initial screening process examines issues such as whether the goods have indeed been imported under preference, whether the complaint is sufficiently specific and whether the complaint appears vexatious or frivolous (Australian Customs 2003c).

- costs incurred in the event of an audit, including time spent preparing documents for Customs and dealing with Customs' enquiries.

As indicated earlier, an arm's-length importer typically does not have the information to calculate the local content of the good and compliance with the RoO. Thus, the responsibility for tracking the local content of the good and compliance with RoO is usually met by the manufacturer of the goods. Indeed, in the case of audits, Customs officials will usually deal directly with the manufacturer rather than the importer. Customs officials have the authority under the CER to make cross-Tasman inquiries.

The level of compliance costs, which is likely to vary between firms, depends on a number of factors, including:

- the size of the manufacturer — large manufacturers may find it easier to set up the necessary accounting procedures and computer programs to prove origin; small manufacturers may be discouraged from exporting under preference by the complexity and evidentiary requirements of the RoO;
- the complexity of the manufacturing process (producers of goods that have more complex manufacturing processes may find it more difficult to calculate the factory cost and qualifying expenditure for the good);
- the regularity of export (regular exporters are more likely to be familiar with the rules);
- the number of goods manufactured and exported (costs may be reduced if manufacturers can spread the costs of familiarising themselves with the RoO requirements over a number of goods, although the number of goods could complicate the calculation of qualifying overheads and labour);
- consistency of manufacturing processes and inputs (the more consistent the process of manufacture and the sources of materials, the less frequently a manufacturer will have to check that its goods meet origin requirements); and
- the proximity to the 50 per cent limit (the more marginal a good is in terms of qualifying for preference, the more frequent and rigorous a manufacturer's monitoring may need to be).[2]

## How significant are these costs?

To demonstrate the complexity of the calculations required by the RoO, the Australian Customs gave the example of one (anonymous) company's calculations of origin for its goods. The calculations covered five spreadsheets, most of which are several hundred lines long. The spreadsheets contain extensive information on the materials, labour and

[2] In addition, companies that are closer to the 50 per cent threshold may have a greater incentive to engage in defensive strategies (such as currency hedging).

overheads of the company, including details of invoices, expenses, financial transactions and specific workers' wages.

Many companies have indicated that they find the RoO difficult and costly to understand and apply. For example, Hart Manufacturing submitted that:

> … the regulatory and compliance burden at present is difficult … producers are confused as to what evidentiary requirements are needed [and] … information gathering in its present state is time consuming through uncertainty. (sub. 1, pp. 2–3)

Business New Zealand noted that:

> … compliance requirements under the Rules of Origin are onerous and require vigilance and the production of considerable paperwork. This means that there are high compliance costs associated with developing and maintaining systems to determine actual costs on the date of shipment and for overall day-to-day monitoring. … The complexity of the Rules of Origin requirements, particularly around the local content requirement, causes considerable compliance costs for many manufacturers. While some of the larger businesses that have had a long track record in exporting have the experience and capacity to cope with the Rules of Origin, there are a growing number of smaller niche manufacturers, particularly in the fashion industry, who have only recently begun exporting over the past few years. Many of them are finding the Rules of Origin to be particularly complicated and costly to comply with. (sub. 7, pp. 5–6)

Cue Design, an Australian clothing manufacturer and retailer, argued that:

> … onerous conditions are placed on Australian and New Zealand manufacturers to substantiate factory works costs (fwc) and qualifying content (50% of fwc). (sub. 6, p. 2)

In order to prove that RoO have been met, Cue Design has:

> … modified its garment costing software to include separate costing sheets incorporating the New Zealand authorities' requirements for each style manufactured in Australia. (Cue manufactures approximately 500 styles per season in Australia.) This takes into account items such as the origin of each material input, (initially, a separate fabric costing is also produced for New Zealand Customs purposes), deduction of the individual maker's profit percentage and exclusion of design and related costs. There is also considerable administrative effort involved [in] ensuring each style in each shipment is correctly declared for origin and duty purposes prior to shipment to New Zealand. (sub. 6, p. 3)

Similarly, to prove origin, Cambridge Clothing has:

> … redesigned our accounting systems to produce live data that would allow us to measure accurately the proportion of CER cost content in each individual product. Each day we run a report listing items about to be manufactured for export to Australia. The report itemises cost by qualifying and non-qualifying elements as defined by the ACS

> [Australian Customs Service] and identifies any items that do not qualify and the amount by which they fall short. It uses the actual landed cost of the relevant shipment of the raw materials and the current qualifying manufacturing costs. … As a final check we run another daily report of all items being despatched for export that day to identify any that fail to qualify. … The one-off cost of designing and implementing the system was approximately $30,000. The annual cost of monitoring the reports and taking appropriate action varies between $5,000 and $12,000 depending on the number of items needing treatment. … Periodically we re-calculate the rates for both direct labour costs and overheads on the ACS approved basis and submit these to the ACS for their approval. This takes two and a half weeks at a cost of around $5,000 and needs to be done every year or so. (sub. 19, pp. 3–4)

Fisher & Paykel indicated during industry visits that it has enhanced its computer systems specifically for tracking the origin of inputs to the manufacturing process in order to prove that origin requirements have been met. It indicated that it takes about one month per year for one person to keep track of all inputs into the manufacturing process using this system.

In response to Cue Design's submission, New Zealand Customs submitted that:

> The nature of the CER RoO places significant cost burdens on importers and manufacturers to evidence compliance. Factors such as choppy [foreign exchange] movements force manufacturers, particularly those that marginally achieve the 50% thresh-hold, to constantly revise manufacturing costs. There are, for example, recorded instances where a size 10 garment will qualify but a size 12 >16 will not. Indeed, for small to medium enterprises (SME's) anecdotal evidence suggests the administrative burden is a disincentive to dipping their toes into trans-Tasman manufacturing or simply declaring their goods to be Australian - Non Qualifying. (sub. 21, p. 4)

In contrast, the Australian Industry Group said that in its communications with its members it has 'not found any aspects of the administration of the current rules of origin to pose any problems' (sub. 4, p. 5). It further suggested that:

> The existing evidentiary requirements for RoO under CER are not viewed by industry as difficult to meet. The information-gathering and record-keeping requirements are also seen as no more onerous than the tax records companies are already required to maintain. (sub. 4, p. 7)

Firms which are audited incur additional compliance costs. At the very least, the firm will have to check its origin calculations, gather the necessary documentary evidence and deal with any enquiries from Customs officers. While the small number of audits undertaken will limit the aggregate compliance costs associated with audit activity, some firms have found audits costly. For example, Fisher & Paykel and Cambridge Clothing both told the Commission that they had been audited on a number of occasions and that these audits (especially the first ones) had taken up a significant amount of their time. Following these experiences, both companies have established more detailed computer systems to track the local content of their goods more accurately (see above). The uncertainty caused by the

potential ex post removal of preferential status following an audit also imposes compliance costs on firms. Coles Myer identified this problem:

> The prospect of post importation audit activity overturning preference eligibility status is a cause of enduring anxiety. (sub. 31, p. 1)

One way of estimating the *maximum* level of costs of complying with CER RoO is to consider the amount of duty that a firm avoids paying by complying with those rules. If the compliance costs were greater than the saving in tariff duty, then the company would not gain by proving origin for its goods. For example, where a firm faces a 5 per cent tariff and continues to claim origin for its products, its costs of complying are likely to be less than 5 per cent of the value of the goods. An estimate of the duty forgone for 2001-02, based on trans-Tasman trade and the MFN tariff rates in Australian and New Zealand, is around A$250 million (Commission estimate).[3] As this is an upper limit, the actual compliance costs are likely to be considerably less than this.

Another way to estimate the *actual* level of compliance costs would be to benchmark the estimates of cost to available information on compliance costs in other agreements. If the costs of compliance under the CER were around 1.5 per cent of the value of trade (the lower of the estimates outlined in section 6.1), this would imply that the total compliance costs associated with the CER RoO were around A$70 million in 2000.[4] Even this estimate could be on the high side, given the relatively uncomplicated nature of the CER RoO.

FINDING

*It is estimated on the basis of overseas research that the costs of complying with CER RoO are less than A$70 million per year.*

FINDING

*Compliance costs take several forms and vary from company to company. Small, irregular exporters, in particular, might find them to be significant, to the point where some are discouraged from entering trans-Tasman trade or simply choose to pay the MFN tariff rate.*

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3 In general, trans-Tasman trade is not subject to tariffs. The estimates of tariff revenue forgone are based on (summation of) the value of imports (from the partner country) for each 6-digit tariff item multiplied by the MFN rate of duty for each item. Nevertheless, some duties that are forgone due to CER preferences would have been refunded to the manufacturer in any case through regular duty drawback provisions. Thus, the estimate expressed above is an upper limit for the duty forgone by Australia and New Zealand due to CER tariff preferences.

4 Based on the trans-Tasman bilateral trade value for goods with a MFN tariff greater than zero (A$4.6 billion in 2000).

## 6.4 Costs incurred by Customs in administering RoO

Australian and New Zealand Customs agencies are responsible for the administration of the RoO for the CER (and other agreements to which the countries are a party). The agencies have three main responsibilities with regard to the administration of RoO under the CER, namely:

- informing importers and manufacturers about the RoO;
- providing rulings about the origin of goods; and
- ensuring compliance with the RoO.

Various documents have been developed to inform business of the RoO, the process for proving origin and Customs procedures followed when auditing origin claims (Australian Customs 2003a, 2003b, 2003c, New Zealand Customs 2003a, 2003b, 2003c, 2003d). In addition, the Customs agencies maintain web pages which provide RoO information, and handle direct enquiries from manufacturers and importers about the RoO. The cost of these activities will be lower the more simple the RoO are and the easier they are to understand.

Australian Customs has indicated that it receives a regular flow of requests for advice about the CER RoO. The majority of these requests are satisfied by referring the inquirer to the available documents describing the RoO and businesses' responsibilities. Australian and New Zealand Customs have been unable to provide the Commission with information about the cost of giving this advice. Nevertheless, in the case of Australian Customs at least, the ease with which most requests are dealt with would limit the total costs of these requests.

Australian and New Zealand Customs also provide interpretations of the RoO and advice on the treatment of specific costs and circumstances. In addition, they can issue joint interpretations for enquiries that pertain to both jurisdictions. New Zealand Customs has indicated that, over the period from January 2002 to October 2003, it issued only one interpretation, at an estimated cost of around NZ$400 in staff time (less the standard application fee of NZ$40). Australian Customs has indicated that it is yet to issue a joint interpretation with New Zealand Customs and that all other requests for advice are dealt with on a case-by-case basis without use of a formal interpretations system.

Australian and New Zealand Customs undertake a range of audit activities in order to ensure compliance with the RoO. The general procedures followed during an audit were outlined in section 6.1. Customs are obliged to investigate complaints or inquiries into the origin status of goods. In addition, they may also undertake 'random' audits. New Zealand Customs submitted that:

> … to ensure trade in goods partly manufactured within the CER area remains discrete to the CER partners there is a considerable burden placed upon the Customs Services of

> Australia and New Zealand in auditing imports claiming ANZCERTA preference. (sub. 21, p. 2)

Australian and New Zealand Customs have advised the Commission that they are unable to separate the costs of auditing origin compliance from other border inspection and auditing activities. Nevertheless, as noted in chapter 5, the level of compliance checking activity would appear to be quite low, suggesting that the total costs incurred by Customs in verifying origin compliance may be relatively small.

With regard to overall administration costs, Australian and New Zealand Customs appear to have disparate views. Australian Customs considers that 'the RoO for ANZCERTA do not pose any significant administrative issues' (sub. 24, p. 1), while New Zealand Customs states that:

> … the RoO also impose a significant burden on the Customs administrations to ensure compliance - that foreign goods are not unlawfully introduced, that domestic manufacturers receive the protection afforded by the respective tariffs and that accurate statistics are gathered. (sub. 21, p. 4)

The Commission considers that, while the complexity of the factory cost method could lead to high compliance costs, the self-assessment mechanism for entering goods, coupled with the small number of audits undertaken is likely to reduce the administrative burden placed upon the Customs Services.

## 6.5 Compliance and administration costs under multiple RoO

In 2003, Australia's free trade agreement with Singapore came into effect. Since then, Australia has completed negotiations for agreements with the United States and with Thailand (although approval processes for both agreements are yet to be completed). New Zealand has an agreement with Singapore and is considering agreements with Hong Kong and Chile.

RoO around the world differ from agreement to agreement, with each rule imposing distinctly different conditions under which origin is to be claimed. To illustrate these differences, box 6.2 outlines the different RoO applied to one product under four different agreements.

Until recently, RoO were fairly consistent across Australia's trade agreements. That is no longer the case. Australia's DITR submitted that:

> The Government's interest in pursuing bilateral trade liberalisation, where there are benefits to Australia, makes it likely that the issue of consistency will become increasingly significant. (sub. 16, p. 7)

The growing number of such agreements and the differences in rules of origin that apply in each case have the potential to raise compliance and Customs administration costs significantly.

Even if based on the same model, RoO associated with new agreements are likely to differ in detail and impose a separate set of compliance costs upon manufacturers. New RoO will take time and effort to understand, and the implementation of the rules may require different documents and calculations to prove origin. In addition, firms are likely to have to establish new systems for tracking origin. As noted in section 6.3, these systems can be expensive and time-consuming to implement and maintain.

Business concerns about the implications of multiple RoO were reflected in submissions to this study. For instance, the Australian Industry Group noted that it has:

> … some concern over the growing complexities facing Australian exporters who are now required to comply with different RoO regimes under the various trade agreements negotiated, and being negotiated, by our Federal Government. … there is likely to be growing costs to companies in administering different systems of rules of origin for each agreement Australia enacts. (sub. 4, pp. 5–6, 7)

And the Australian Made Campaign argued that:

> For Australia changes to the existing system or the adoption of another system for the purposes of an FTA with a particular country (eg. the Australia – US FTA) would add to the complexity for trade and commerce of complying with rules of origin because it effectively means operating two or more systems for determining where a product is made. For some manufacturers that could also mean two or more sets of processes, two sets of paperwork, two sets of labelling, etc. etc. The cost impost, particularly for small businesses, could be considerable and may deter some firms from exporting. (sub. 5, p. 15)

## Box 6.2 **RoO in different trade agreements**

Where a country is a member of multiple PTAs, it is common for different RoO to be adopted under each agreement. Differences can be significant and are likely to increase the costs of complying with and administering the rules. To illustrate the differences, this box outlines the RoO applied to one good — "electronic integrated circuits and micro-assembles" (HS: 8542) — under four separate agreements.

*ASEAN Free Trade Agreement*

This agreement allows origin to be conferred on any good if the total value of inputs from non-ASEAN countries does not exceed 60 per cent of the value of the good produced (provided that the final process of manufacture occurs in the exporting member state).

*North American Free Trade Agreement (NAFTA)*

NAFTA requires that for products of the tariff heading 8542 to be considered originating they must have been transformed such that the sub-heading (6-digit tariff classification) of the final good is different from the sub-heading of the imported material inputs.[5]

*European Union–Lebanon*

This agreement (the most recent of the EU's Euro-Mediterranean agreements) requires that for products of the tariff heading 8542 to be considered originating they must have undergone:

- manufacturing such that the value of all the materials used does not exceed 40 per cent of the ex-works price of the product; and within the above limit, the value of all the materials of headings 8541 and 8542 used does not exceed 10 per cent of the ex-works price of the product;
- manufacture in which the value of all the materials used does not exceed 25 per cent of the ex-works price of the product; or
- for goods of subheading 8542.10 to 8542.30, the operation of diffusion (in which integrated circuits are formed on a semi-conductor substrate by the selective introduction of an appropriate dopant), whether or not they are assembled and/or tested locally.

*Singapore–United States*

This agreement allows products of sub-heading 8542 to be traded without having to prove origin.

*Sources:* ASEAN (2003), EU (2002), OAS (2003a and b).

[5] Additional provisions apply where the good is subject to further processing outside NAFTA for subsequent re-import.

Customs administration costs will increase if a number of PTAs with disparate RoO are in place. Customs staff would need to be trained to administer these rules and to understand fundamental differences in methodologies and evidentiary requirements, as well as more subtle nuances. Customs officials would need to implement multiple sets of RoO and educate firms about the various rules. Furthermore, as the proportion of trade covered by preferential agreements increases, Customs will have to educate more companies about their responsibilities under the rules, as well as check compliance on a greater volume and wider range of imports.

FINDING

*Multiple PTAs with different RoO add to compliance and administration costs. With differences in the 'fine print' between RoO based on the same model, these costs seem unavoidable.*

## 6.6 Concluding comments

The CER RoO impose compliance costs on business and administration costs on government. The complexity of the factory cost method of determining origin is the main source of these costs.

Firms regard the current factory cost method as being difficult to understand and argue that checking origin is onerous. This is reflected in the fact that some companies have incurred considerable expense in setting up computer systems to track the origin of their goods so as to be able to demonstrate that they meet the RoO. In addition, the audit process imposes further costs upon businesses that are audited.

Research on overseas agreements suggests that the cost of complying with RoO range from around 1.5 per cent to 6 per cent of the value of the products traded. However, the CER RoO are simpler than those in other agreements and the annual costs of complying with them are probably less than A$70 million.

The CER RoO also impose costs on Customs administrations, principally through the need to inform firms of their responsibilities under the RoO and to audit companies for their compliance with the RoO. These costs are much less than the compliance costs borne by firms. In particular, the aggregate costs of audit activity are limited by the low number of audits undertaken.

In addition, the spread of PTAs with different RoO is likely to raise the complexity of the trading system faced by firms (and government) and thereby increase compliance and administration costs — potentially significantly.

# 7 Design principles

The analysis in chapter 4 shows that adverse economic effects associated with PTAs — including CER — can detract from the benefits stemming from reduced trade barriers between member countries. The RoO can contribute significantly to the balance between favourable and adverse effects. The previous two chapters provide evidence that the CER RoO can impose significant compliance and administration costs on business and government, penalise innovation and productivity improvements and lead to inefficiencies in purchasing decisions. This chapter seeks to identify some design principles to keep these costs to a minimum and to help ensure that a PTA provides sustainable welfare improvements.

## 7.1 General design principles for RoO

Rules of origin have existed since the introduction of trade laws that discriminated between countries (Lloyd 2002). While there are some guidelines on RoO in *non*-preferential trade (chapter 3), these do not apply to PTAs such as the CER. However, the 1973 Kyoto Convention recommended that methods for determining origin be those which:

> ... can be most easily applied and controlled, with least risk of misunderstanding and fraud and the least interference with commercial activities. (WCO 1975)

The APEC agreement went a little further and required member countries 'to ensure a predictable and consistent application of rules of origin' (PECC 1998, p. 85). In general, however, the RoO within PTAs are negotiated directly by the countries concerned, with little in the way of established principles to guide their design.[1]

As RoO are a form of regulation, guidelines that have been established for the introduction of 'best practice' regulation are relevant to their design. At a general level, Argy and Johnson (2003) drew together conclusions from ORR (1998) and other sources to recommend that high quality regulations should be:

- the minimum necessary to achieve objectives;
- not unduly prescriptive;

[1] As noted in chapter 3, while the WTO's Agreement on Rules of Origin contains a Common Declaration about preferential RoO, all harmonisation efforts to date have concerned non-preferential RoO only.

- integrated and consistent with other laws;
- minimal in terms of the compliance burden imposed;
- accessible, transparent and accountable;
- communicated effectively; and
- enforceable.

Translated into the context of a PTA, this suggests that RoO should be simple and consistent with the country's other legal requirements (in the broadest sense) and conform with objectives embodied within the PTA. Furthermore, RoO should be straightforward to implement and enforce, impose minimal costs on firms and government, and impose similar obligations on all sectors.

Some previous attempts have been made to compose a set of recommendations on how RoO should be designed and specified. Stephenson (1997) focused on a possible definition of an 'optimal' RoO, which she defined as one 'which permits the maximum amount of [net] trade creation to occur for a given level of prevention of trade deflection' between partner and third country economies. However, a concern expressed about this definition is that it gives prominence to the 'defensive' aspect of RoO, rather than the welfare-creating potential of reductions in border assistance.

Moïsé (2002) referred to the WTO Agreement on Rules of Origin to propose that RoO be:

- neutral — RoO should not be instruments to create restrictive, distortive or disruptive trade effects or be based on conditions unrelated to the manufacturing process, such as the environment;
- non-discriminatory between industries or trading partners outside the PTA — RoO should observe national treatment and the MFN principle;
- transparent — RoO should provide a clear definition of the requirements which confer origin; and
- predictable and supported by processes to ensure consistent, uniform, impartial and reasonable application, and have mechanisms for judicial or administrative review of origin determinations.

While Moïsé pointed out that these principles already apply to non-preferential RoO under the WTO Agreement on Rules of Origin, she also noted that, in a Common Declaration annexed to that agreement, WTO members agreed to observe the same principles when they use RoO to determine whether goods qualify for preferential treatment. The 'obvious exception' to this concerns 'principles that are incompatible with the concept of a

preferential trade regime, such as the principle of non-discrimination' (p. 6).[2] These principles make no specific mention of the need to avoid undue costs associated with RoO.

On a more prescriptive level, Brenton (2003) suggested a definition that is oriented to the avoidance of compliance and administration costs. He recommended that preferential RoO should be:

- simple, consistent and predictable, with minimal costs to firms in adhering to them;
- not vary unduly across products and agreements, so as to reduce complexity, compliance and administration costs;
- allow for widespread cumulation and substantial tolerance margins, in order to offset the restrictiveness of rules; and
- avoid restrictive rules targeted at sensitive products.

Inherent in this is the need to avoid the creation of RoO which become instruments to pursue industry policies or restrict trade, as such rules could raise further the costs associated with the PTA.

During the Commission's study, the New Zealand Government agencies suggested criteria that should inform consideration of any changes to the future design of the CER RoO (sub. 20, pp. 14–15). Broadly, they suggested that:

- the definition of substantial transformation used should be simple, transparent and predictable;
- generally-applied rules are preferable to product-specific rules (in keeping with the principles of the CER Agreement);
- the RoO should be simple and involve low compliance costs for firms and Customs administrations; and
- the RoO should be predictable and based on transparent rules and processes.

The agencies also suggested that any substantive change to the RoO should:

- encourage productivity and efficiency gains within the trans-Tasman market and support efforts by New Zealand and Australian firms to become more internationally competitive;
- be underpinned by a clear understanding of trade flows and the implications for specific sectors;

[2] The principle of non-discrimination is not repeated in the Common Declaration on preferential rules.

- be a significant advance over the current regime — with the benefits of possible lower compliance costs under any new regime being weighed against the benefits of marginally amending existing systems which are well understood by firms; and
- be consistent with internationally acceptable approaches.

The agencies also advocated the incorporation of automatic adjustments to take account of expected changes to the external tariff regimes of both parties over the next decade and to allow increased dynamic gains to be realised. They also argued that the RoO should be less susceptible to external exchange rate fluctuations.

## Proposed design principles

Experience shows that the formulation of RoO is not independent of the PTA of which they form a part. As noted, WTO members have been unable to reach agreement on more than a few basic principles which should guide the development of preferential RoO. Very little progress has been made towards harmonisation of such rules.

Nevertheless, the various principles outlined above provide useful guidance. Some of them appear to be aimed at constraining the potential adverse economic effects of RoO, such as undue restrictions on trade or significant transactions costs. Others, such as the need for neutrality, simplicity, transparency and similar treatment of all industries, are cast in a more positive sense.

On the basis of these ideas, and consideration that RoO should enhance the prospect of a PTA delivering net welfare gains to its member countries, a set of general principles to guide the design of RoO is presented in box 7.1.

FINDING

*To realise fully the potential benefits of bilateral tariff reductions from a PTA, RoO should be guided by a set of principles designed to ensure that the rules enhance the prospect of a PTA delivering net welfare gains to its member countries.*

Box 7.1 **RoO design principles**

To help ensure that the potential benefits from a PTA are fully realised, RoO should:

- include a clear and unambiguous statement of their objective;
- conform with the goals of the PTA;
- be consistent with the country's international obligations;
- avoid product-specific rules;
- avoid undue distortions in the allocation of resources and associated reductions in economic efficiency;
- facilitate organisational and technological innovation and the capacity of producers to respond to changes in consumer tastes;
- minimise compliance costs for industry;
- minimise administration costs for government;
- be certain and consistent in the determination of origin; and
- operate in a transparent and accountable manner.

## 7.2 What these principles mean at a practical level

Ideally, the design of RoO in a PTA would comply fully with each of the principles in box 7.1. In practice, however, the presence of tariff and non-tariff barriers that differ between countries, together with other factors specific to the economies of particular members of a PTA, can be expected to make it difficult to achieve full compliance with some of these principles or simultaneous compliance with all of them.

Hence, some trade-offs between these design principles are likely — for example, the mere introduction of RoO that conform to the goals of the PTA would distort the allocation of resources and raise the costs to the economy, relative to a situation of multilateral liberalisation. This means that application of the design principles should be aimed at moving toward unrestrictive RoO and ultimately, freer trade, rather than toward RoO which reinforce the discriminatory nature of a PTA.

It is therefore useful to examine some of the implications that these principles may have for the way in which RoO are formulated in practice. The first three principles relate to the objectives of RoO and their general context. The remaining seven relate to the operation of RoO and are therefore a function of the approach chosen to determine origin in particular PTAs.

## Issues relating to the objectives and context of CER RoO

### *Defining the objectives of RoO in context of a PTA*

Although trade agreements contain provisions that set out RoO that must be met before preferential tariff rates can apply, very few PTAs identify criteria or objectives governing the formation of their rules.

The CER agreement, for example, sets out (in article 3) the conditions which confer origin. Australian Customs interprets these conditions as follows.

> The principal objective of setting rules of origin in relation to the administration of a preferential trade agreement is to ensure that the benefits created by the agreement are applied only, or mainly, to those goods which originate, and are traded within, the particular preferential area. (ACS 2003c, p. 189)

Similarly, APEC said that the principal objective of preferential rules of origin:

> … is to ensure that benefits are restricted to those goods which originate and are traded within the particular preference area. (1997, p. 5)

In its view, RoO are necessary to ensure that the provisions of an agreement are not circumvented by, for example, minimal processing activities (for which preference is subsequently claimed) or trade deflection (APEC 1997, p. 5).

Such interpretations align fairly closely with that of the WTO, which suggested that 'the basic purpose of RoO is to prevent trade deflection' (1995).

However, they raise the crucial question of whether the objective for RoO should be expressed simply in terms of eligibility criteria for a preferential tariff or whether it should incorporate the broader objective of improving community welfare.

Clearly, no member country would seek a set of RoO that reduces its own welfare in order for another member country to sustain a welfare gain. Instead, it is likely that each PTA member will seek a set of RoO that enhances its own welfare, and negotiate accordingly.

Other factors being equal, a sustained welfare improvement is more likely if the RoO do not impede reductions in the real cost of inputs (at an economy-wide level) to the member economy.[3] In addition, they should not impede technological or organisational change.

The RoO objectives should be explicit and remain focused on the broader welfare objective. Attempts to combine industry policy objectives with a trade-liberalising

[3] Because RoO may lead to trade diversion and raise compliance and administrative costs, it does not necessarily follow that there exists a set of RoO which will afford each PTA member a net increase in welfare.

objective — such as the RoO that evolved in NAFTA to encourage investment in certain sectors and provide incentives for local production and sourcing (Mayer 1998) — are likely to be detrimental to welfare.

A welfare focus would suggest that, as a minimum objective, RoO should not used as an instrument for *increasing* border protection afforded to producers in participating economies nor as a means to compensate them for differences in input costs or tariffs on inputs between member countries (chapter 5).

FINDING

*It would not be appropriate to use preferential RoO in trade agreements:*

- *as a substitute for tariff assistance, particularly to compensate for increased competition arising from bilateral tariff reductions implemented through the PTA; or*
- *to implement specific industry policy objectives, such as encouraging investment in a particular activity or region.*

### *Conforming with the goals of the PTA*

Typically, the goals of PTAs are set out in general and higher level terms. For example, the goals of the CER are:

- to strengthen the broader relationship between Australia and New Zealand;
- to develop closer economic relations between the Member States through a mutually beneficial expansion of free trade between New Zealand and Australia;
- to eliminate barriers to trade between Australia and New Zealand in a gradual and progressive manner under an agreed timetable and with a minimum of disruption; and
- to develop trade between New Zealand and Australia under conditions of fair competition.

RoO design-related questions implied by these goals include:

- do the RoO constrain expansion of trade between Australia and New Zealand in the context of the existing trade barriers maintained by each country? and
- do the RoO act as an impediment to the elimination of trade barriers between Australia and New Zealand?

Because of the discriminatory nature of RoO while border protection remains, there is likely to be a degree of tension between the broad objectives of an agreement and the impact of RoO on trade.

### *Complying with international obligations*

Article XXIV of the General Agreement on Tariffs and Trade allows countries to afford preferential treatment to partners in a regional trade agreement, provided that it performs a trade-liberalising function and does not encourage the establishment of new barriers or provide an easy route to introduce new measures which discriminate between trading partners. The crucial test is that the agreement must eliminate all tariffs and other restrictions on substantially all trade in goods between its member countries.

## Issues relating to the method used to determine origin

### *Promoting efficiency*

RoO which support the discriminatory nature of a PTA can maintain or increase inefficiencies and thereby incur economic costs. The more restrictive that RoO are, the higher are the costs to the economy (chapter 4).

Some suggest that such costs would be avoided by RoO which are specific to each product and each source.[4] However, such a regime would be extremely demanding of information and would involve considerable administration costs and bureaucratic judgment. There is no generally agreed economic interpretation of how much transformation is 'substantial', and what may be considered the 'efficient level' will vary from product to product.[5] It would also require action to offset protection afforded to intermediate-good producers in the PTA by assisting final good producers. Moreover, industry-specific RoO are akin to different tariffs for different industries — a source of misallocation of resources and economic inefficiency.

RoO that have a uniform degree of minimum transformation across all tariff items have the appeal of horizontal equity and would be less easily manipulated to achieve industry policy objectives — and thus result in a more efficient allocation of resources, and impose lower economic costs on member countries than industry-specific RoO. Stephenson (1997) views uniformity in the approach taken to determine origin as critical. Indeed, she suggested that, to ensure maximum neutrality in the process of origin determination, PTAs should be considered GATT-legal only if a single method of determining origin is used for all products.

4 Rosellón (2000) said that the optimal RoO may vary from industry to industry, depending on specific market and technological features.

5 See Rodriguez (2001).

### *Avoiding impediments to innovation*

The approach chosen to determine origin should not be such as to constrain firms' productivity — for example, by requiring them to use outdated labour-intensive methods of production. Nor should it require frequent and detailed updating to ensure that it remains a valid test of the extent to which goods have been transformed within the PTA. RoO which become outdated are unlikely to accommodate new products, organisational innovation and technological advances in production. As a result, they are likely to encourage inefficiencies in the allocation of resources within and between member economies.

### *Minimise compliance and administration costs*

Compliance and administration costs differ between different approaches and increase when a country uses multiple RoO to determine origin. Evidence indicates that, for some producers, the benefits of lower trade barriers may be offset by the compliance and administrative costs of RoO.

Avoidance of undue public administration and business compliance costs is facilitated if the RoO are readily implemented and enforceable by customs authorities and do not require a substantial amount of information to be provided by those engaged in trade. Private (or firm) costs of compliance with RoO will be lowest if the amount of information required can be readily drawn from firm records. At a practical level, avoidance of these costs may be facilitated if a country adopts a set of RoO based on a single calculation method and applies this uniformly across all PTAs of which it is a member.

### *Providing continuity and consistency in determination and administration of origin*

As far as possible, rules should provide for determinations of origin which are unambiguous and consistent, both for a given product across firms at a point in time and for a given trade undertaken by a firm at different points over time. This means that the origin of a final product should be determinable by the manufacturer prior to export and not be sensitive to changes in factors, such as exchange rates, that are outside the manufacturer's control. The RoO should not require frequent administrative interpretation of their meaning. They should be applied consistently by the Customs authorities of the PTA member countries.

### *Operating in a transparent and accountable manner*

Transparency is enhanced if rules are expressed in a simple and precise way, without recourse to supplementary tests or lists of exceptions. At an administrative level,

transparency is facilitated if rules are published promptly and widely, with clear explanations of any calculations necessary to determine the extent of product transformation. Transparent RoO should help to avoid lengthy and costly dispute resolution procedures.

To facilitate public accountability of origin determinations, RoO implementation should not rely on detailed industry information or knowledge. Falvey and Reed (1998) add that rules should not require that a product be disassembled or tested to determine its origin; a paper trail should suffice. Accountability is further enhanced if there is an established system in place for administrative or judicial review of origin determinations.

# 8 Options for change

Chapters 5 and 6 have shown that there is a range of problems in the operation and implementation of the current CER RoO which, contrary to the objectives of CER, restrict export opportunities and market access for Australian and New Zealand firms.

This chapter presents and evaluates various options for changes to those rules. Some involve relatively small changes, while others are more substantial. In assessing possible design and model changes, this study has had regard to the goals of the CER and draws upon the design principles outlined in chapter 7. The benefits and costs that would be involved in introducing possible changes are also considered. These options are outlined against a background of scheduled tariff reductions in Australia and New Zealand, the APEC commitment to 'free trade' by 2010 and recent Government initiatives to develop a single trans-Tasman economic market.

## 8.1 Determination of substantial transformation

As noted in chapter 3, the Kyoto Convention[1] of 1973 laid down the general principle that the origin of goods should be determined by the last or final country where the good was 'substantially transformed'[2] and that substantial transformation could be determined by one of three different methods:

- a change in tariff classification (CTC) rule;
- a percentage of value added (or regional value content) rule; or
- a technical test (or specified process of manufacture) rule.

The application of these methods typically is not straightforward and involves a number of provisions — for example, CER RoO have a last place of manufacture test plus the regional value content (RVC) rule, and NAFTA has a CTC rule supplemented in some cases with a RVC rule and/or technical test. Nevertheless, each PTA is characteristically

1 The International Convention on the Simplification and Harmonization of Customs Procedures (see United Nations Economic Commission for Europe 2003).

2 The Convention did not distinguish between preferential and non-preferential RoO. The WTO noted that 'sufficient working or processing' is a comparable concept in the context of preferential RoO (WTO 2002, p. 4).

associated with *one* rule — for example, CER with the RVC rule and NAFTA with the CTC rule.

Two of the above methods, and some possible optional approaches within each, are assessed in this chapter, namely:

- regional value content (section 8.2); and
- change in tariff classification (section 8.3).

The technical test method is not evaluated in this chapter.[3] It was not advocated during the course of the study for use in CER and appears to have a number of major disadvantages.[4]

This chapter also includes several other options. Section 8.4 looks at the possibility of relying only on a standard definition of manufacture. Section 8.5 examines RoO waiver provisions which could be used in conjunction with other methods for determining origin.[5] Section 8.6 assesses the use of tariff-based options which would remove the need for RoO.

## 8.2 Regional value content approach

The CER is identified with a RVC method of origin determination for goods manufactured in a member country. Specifically, to be granted preferential treatment, goods must meet two tests:

- the last process of manufacture must be performed by the 'manufacturer' in either Australia or New Zealand; and
- not less than 50 per cent of the factory cost of manufacturing the good must represent qualifying expenditure (which comprises CER-sourced materials, allowable factory overheads and allowable labour — chapter 5).

There is a range of possible design changes to the broad CER RVC rules that may be considered as options. They would not involve a shift from the current basic model for determining origin. These options are as follows:

- replacing the 'manufacturer' with the concept of 'principal firm';
- revising the definition of manufacture;
- reducing the current regional value content threshold;

[3] Under this method, the origin of a product is attributed to the country in which a specified manufacturing or processing operation is undertaken.

[4] For example, it requires different rules for different products; it is easy to manipulate and to use as an instrument of industry assistance; and it requires regular updating.

[5] De minimis rules and cumulation provisions were discussed in chapter 3. While the inclusion of such features has some merit, the scope for them to reduce the costs of CER RoO is limited.

- changing the method of calculating regional value;
- relying solely on a minimum regional value requirement; and
- aligning the treatment of allowable expenditure in Australia and New Zealand.

These changes, which are not mutually exclusive, are discussed in turn below.

## Replace 'manufacturer' with 'principal firm'

Under this alternative, the 'principal firm' rule would state that transformation occurs at the firm which performs, *or has performed on its behalf*, the last process of manufacture of the goods in the CER region. This rule is very similar to the 'principal manufacturer' rule in the Singapore–Australia FTA (SAFTA).[6]

The qualification 'or has performed on its behalf' would indicate that origin is assigned on the basis of a firm maintaining ownership and control of a good, even if that firm sub-contracted all or part of the manufacturing process to others within the PTA region.

### *Advantages*

Changing to a 'principal firm' test would have some significant advantages over the current CER rule. It would:

- address the problem faced by those 'outsourcing' local content within the CER region by including a broader definition of the term 'manufacturer'; and
- be more consistent with the intent of CER to confer preferential treatment on goods that meet the *regional* content requirement.

Under the current CER RoO, only the expenses incurred by the 'manufacturer' *at* the 'last place of manufacture' are included in the factory cost calculations. As a consequence, substantial local content incurred within the CER, but not at the last place of manufacture, may not be counted as regional value under the rules.

Under this rule, the local qualifying material, labour and overhead expenses incurred by the 'principal' at each stage of the manufacturing process would count towards the 50 per

6 Article 3(1)(c)(ii) of the Singapore–Australia Free Trade Agreement states that the following must occur: one or more processes of manufacture was, or were, performed in the territory of the Party by, or on behalf of, the principal manufacturer; one or more processes was, or were, performed in the territory of the Party by, or on behalf of, the principal manufacturer immediately prior to export of the goods to the territory of the other party; and the principal manufacturer in that Party incurred all the costs associated with any process performed in the territory of a non-Party.

cent RVC requirement, regardless of whether the production is undertaken in-house or outsourced. This would better reflect the aims of CER.

Use of the term 'principal firm' rather than 'principal manufacturer' (as used in SAFTA) would make it clearer that the firm organising the manufacture of the goods need not be a 'manufacturer' as such. For example, a wholesaler might, as the principal firm, arrange for the manufacture of goods on its behalf.

Adoption of this test would provide an effective low-cost solution to the anomalies caused by outsourcing — one of the more significant operational problems with the CER RoO. At the same time, it would not involve significant change from current practice for the majority of exporters and importers.

This problem has been recognised by both government and industry in Australia and New Zealand. Following the *Joint Ministerial Statement on Rules of Origin* issued by the Australian and New Zealand Trade Ministers at the CER 20th Anniversary Ministerial Forum in August 2003, both countries agreed to introduce the concept of 'principal manufacturer' into the CER. New Zealand implemented this change through regulation in January 2004. However, in Australia, a change in customs legislation is required, and this may take some time to be achieved.

### *Disadvantages*

The introduction of a 'principal firm' rule (as indeed, with a 'principal manufacturer' rule) could result in some additional compliance and administration costs for firms presently near, or under, the threshold. Specifically, the principal firm would need to keep track of not only its own costs, but also the costs of all firms undertaking any stage of production on a contract/commission basis — thus potentially increasing accounting and record keeping costs. However, firms would only choose to incur such costs if they were outweighed by the benefits of doing so (ie through access to preferential entry). With the additional complexity, Customs administration costs could also rise, although any such increase would probably be small.

Overall, these disadvantages are unlikely to be major. The fact that many companies in the TCF sector already operate with outsourced contractors should mitigate the extent of any additional costs.

## Revise the definition of manufacture

To add further clarity, a standard definition of manufacturing could be adopted in the CER agreement. The Commission has identified three potential options, namely:

- continue to rely on the current common law definition, with a more explicit connection to Customs guidance material;
- link the term 'manufacture' to an accepted standard industrial classification system (the Commission's interim proposal); and
- codify the definition through adoption of the SAFTA definition (s. 153UA of the Australian *Customs Act 1901*).

A brief explanation of the common law definition (the first option) is contained in section 5.3, with a more complete analysis in appendix C. This demonstrates that the current common law definition is workable and stable. The second option, linking the definition to an accepted industrial classification system, would involve utilising the *Australian and New Zealand Standard Industrial Classification* (ABS 1993). Division C of the ANZSIC classifies processes as manufacturing only after detailed evaluations by the Australian and New Zealand statistical agencies. Under this option, if a product is created or made in the CER region by a process that falls into division C, it would be assessed as having been through a *process of manufacture*.[7] Importantly, the overarching test for manufacture under this option would still be the common law definition. The third option would use the definition of manufacture contained within s. 153UA of the *Customs Act 1901* — the SAFTA definition (box 8.1). At this stage, this definition applies only to concessional trade with Singapore.

Box 8.1 **SAFTA definition of manufacture**

Manufacture means the creation of an article essentially different from the matters or substances that go into such manufacture and does not include the following activities (whether performed alone or in combination with each other):

(a) restoration or renovation processes such as repairing, reconditioning, overhauling or refurbishing;

(b) minimal operations; and

(c) quality control inspections.

*Source:* s. 153UA *Customs Act 1901* (Cwth).

### *Advantages*

Adopting a standard definition of manufacture would increase certainty among traders and government agencies. Ultimately, the level of certainty would depend on the option chosen. For example, adoption of the legislated SAFTA definition would provide greater certainty than the current Customs guidance supported by the common law definition. The

[7] In the ANZSIC, manufacturing is divided into 9 sub-divisions, 46 groups and 153 classes.

detailed codification under an ANZSIC-based rule may provide some additional certainty once the system is assimilated into traders' and Customs' procedures. However, the current level of disputes about what constitutes manufacture is not high. Australian Customs informed the Commission that there have been around half a dozen cases over twenty years in the two countries, and none during the last seven years.

### *Disadvantages*

Any change from the current CER approach would involve some change-over costs. For example, if the SAFTA definition was adopted, New Zealand would need to change regulations (although that could be done relatively quickly). Legislative change would be necessary in Australia and would take longer. While this should not result in any disadvantages to firms exporting to Australia, the certainty desired by many participants may take some time to be achieved.

While the ANZSIC — the second option — is a well-established and understood classification of industrial activity,[8] its application in a RoO context would be novel. As a consequence, there would be some familiarisation and other change-over costs associated with its adoption, at a time when CER RoO are declining in relevance.

Appendix C demonstrates that the different options, although providing alternative means of defining what constitutes manufacturing, do not differ from the meaning ordinarily attributed to the term 'manufacture'. Consequently, in principle, the economic implications of the methods are unlikely to differ significantly.

Nevertheless, despite the apparent conceptual equivalence of the different options, one may be preferred over another on practical grounds — including familiarity of use by relevant traders and administrative agencies, increased certainty, and expected lower compliance and administrative costs. For these reasons, it would appear that there would be merit in adopting the SAFTA definition for CER trade. This approach received strong support from a range of participants. Australian Customs stated:

> Customs agrees that a standard definition of 'manufacturing' may be advantageous in increasing the levels of certainty and transparency and in reducing CER related compliance and administrative costs … Customs suggests … the adoption of a definition similar to the definition of 'manufacture' in section 153UA of the *Customs Act 1901* … (sub. 32, p. 2)

Similarly, the TFIA submitted:

8 The ANZSIC is also linked to the International Standard Industrial Classification (ISIC), third revision.

> … the most appropriate definition of manufacturing lies again with the SAFTA rules which clearly define what activities can and cannot be classed as manufacture. (sub. 34, p. 5)

While adoption of the SAFTA definition has particular advantages, there would also be merit in considering a role for the ANZSIC codification of manufacturing activities in Customs guidance material. The provision of a comprehensive list of activities which have been assessed as manufacturing — using the same definition — would provide *ex ante* guidance to both Customs and industry.

## Reduce the current regional value threshold percentage

Reducing the RVC threshold would resolve some of the present difficulties. Some Australian and New Zealand participants supported a reduction in the threshold — variously suggesting 40 per cent, 35 per cent, 30 per cent to as low as 20 per cent.[9] However, the Australian Industry Group (sub. 29, p. 3) argued that Australian industry is 'strongly opposed' to any lowering of the threshold.

### *Advantages*

Lowering the current threshold would provide three main advantages. It would:

- allow greater choice in the selection and origin of inputs;
- lower the barriers to trade posed by the RoO;
- allow a greater margin for future technological and organisational changes, productivity gains and currency fluctuations; and
- be simple to implement and involve negligible transition costs.

The New Zealand Government agencies stated:

> Lowering the threshold would go a long way towards dealing [with] the risk that many competitive trans-Tasman businesses face today of failing to qualify for preference. (sub. 20, p. 10)

### *Disadvantages*

Reducing the threshold would have two significant disadvantages. It would not:

[9] For Australian manufacturing industry as a whole, factory overheads and labour costs, by themselves, represent around 30 per cent of total factory cost (ABS input-output tables). This suggests that input choices would not be affected if the RVC requirement was reduced to that level.

- address the compliance and administration costs inherent in the factory cost method; or
- provide a long-term solution to threshold-related problems.

For example, a reduction in the threshold would not alter the fixed cost of establishing accounting systems to calculate allowable inputs, overheads and labour, or the compliance and administration costs associated with the factory cost method — including the need to apportion costs between product lines. Thus, producers would still:

- need to distinguish between local and imported inputs, to cost specific labour and overhead expenses and to allocate costs between the trans-Tasman trade and other trade; and
- experience difficulties in allocating costs to particular locations as a result of the increasingly fragmented and global nature of production processes.

In addition, problems identified with the current threshold (see chapters 5 and 6) would continue to arise for goods that are on the margin at the new threshold. The Australian Industry Group recognised this problem:

> The problem with 'lowering the bar' is that there will always be companies in the margins that do not find the RoO work for them. Further … reducing the threshold does not provide a long-term solution to any of the cited disadvantages of the current model. (sub. 29, p. 3)

EMA New Zealand also noted that a reduction in the percentage:

> … ultimately does not address the problems … Same problems, just a lower level of compliance! (sub. 3, p. 5)

DITR also noted that 'the problem of marginal producers … would remain' under a lower percentage (sub. 16, p. 4).

Although lowering of the threshold might involve some change-over costs, some participants suggested that these are likely to be small. For example, Rembrandt Suits noted:

> A change to 40% can be implemented quickly and will have an immediate and positive impact for manufacturers such as ourselves. (sub. 17, p. 2)

Australian Customs said that, were the RVC threshold to be phased down in several steps, there could be some confusion for goods produced or shipped during each transition period (sub. 32, p. 3).

## Change the method of calculating regional value

Broadly, regional value content can be evaluated by reference to either the:

- cost of 'inputs' (cost-based methods); or
- value of 'output' (transaction value-based methods).

Within either of these approaches, originating content can be calculated as the:

- *sum* of individual qualifying inputs ('build-up' approach); or
- *residual* of regional value less imported materials ('build-down' approach).

This leads to four commonly used calculation methods (box 8.2). The current CER RoO is an example of a cost-based build-up method.

Under both the cost-based and transaction value-based methods, there are options with respect to the point in the production and distribution chain at which the finished preference-claim good, imported (non-originating) materials and domestic materials are valued. The option chosen can result in significant differences in the allocation of originating/non-originating costs. For example, import valuations can be based on ex-works (ex-factory); free on board (fob); cost, insurance and freight (cif); or free into store (fis) prices.[10] The value of non-originating material would be the lowest in the case of the ex-works basis and highest in the case of the into-store basis. Domestic materials are usually valued on an into-store basis (ie as delivered).

A large number of RVC methods and valuation options is available. The Commission has chosen to assess the transaction value build-down (TVBD) method because it has significant advantages relative to other methods and was canvassed in several submissions.[11] Under this method, the transactions value is usually evaluated on a fob basis to reflect the value of the good at the point of embarkation. This basis is consistent with the valuation of merchandise for duty in Australia, New Zealand and many other countries.

[10] A product valued *ex-works* (ie when it leaves the factory) includes the cost of all the materials used minus any internal taxes which may be repaid when the product is exported. In a fob valuation, the costs of local freight and insurance are also treated as originating. In a cif valuation, costs incurred after the imported material has crossed the border are treated as originating.

[11] While the CER RoO are based on a factory cost (build-up) method, Australian Customs essentially uses a transaction value build-down method for determining the percentage of local content in intermediate materials of mixed origin (chapter 5).

Box 8.2 **Possible regional value content methods**

**Cost-based methods**

The *factory cost build-up method*, as used in the CER, is defined as qualifying materials, labour and overheads expressed as a percentage of all materials, plus qualifying labour and overheads.

The *net cost build-down method* is defined as the net cost of the final product less the value of imported materials, expressed as a percentage of the net cost of the final product. Net cost is defined in NAFTA, for example, as all the costs incurred by the manufacturer minus expenses relating to sales promotion, royalties, shipping and packaging costs, and non-allowable interest costs.

**Value-based methods**

The *transaction value build-up method* is defined as the value of locally sourced materials expressed as a percentage of the value of the final product.

The *transaction value build-down method* is defined as the value of the final product less the value of imported materials, expressed as a percentage of the value of the final product.

Since the elements in the calculation of the respective thresholds differ, an equivalent level of protection would require different threshold percentages, depending on the method adopted.

*Sources:* CER, NAFTA and Singapore–United States FTA.

### *Advantages*

Changing the method of calculation to the TVBD method would provide five main benefits. It would:

- recognise transport, distribution, and other services sector inputs in the exporting economy;
- reduce impediments to the efficient sourcing of inputs;
- do away with the need for a 'last place of manufacture' requirement, as the calculation does not utilise the idea of 'factory costs', while retaining a manufacturing test;
- reduce impediments to technological and organisational changes, and to productivity gains; and
- reduce compliance and administration costs.

While compliance costs would vary considerably between products and industries, they would probably be lower under the TVBD method than under the CER factory cost

method, since fewer details are generally required. Australian Customs noted that the build-down method is:

> … considered to be simple for both industry and Customs to use as it does not involve the calculation of the cost to manufacture the goods; it uses only the selling price of the manufactured goods and purchase price of non-originating materials. (sub. 24, p. 6)

Compared with cost-based methods, transaction value-based methods are considered to be administratively simpler and involve lower compliance costs. Krishna and Krueger agreed, noting that that cost information is harder to get than price information (1995a, p. 7).

Both DITR (sub. 16, p. 5) and the New Zealand Government agencies (sub. 20, p. 14) acknowledged that the TVBD method would have lower compliance costs than the current factory cost method.

The purpose of RoO is to exclude goods which have not been produced or have not been subject to sufficient working or processing in a member country. Because the current RoO are based on the notion of factory cost, they ignore the value and importance of a significant proportion of a firm's intermediate inputs and the role of service sector activities in the production and supply process.[12] [13] Under the TVBD fob method, all regional content (including profit, research and development expenses and regional transport and distribution costs) would be included. This method is widely regarded as best reflecting the economic interpretation of substantial working or processing. The New Zealand Government agencies submitted:

> Using FOB would allow for additional cost to be taken into account, including a full new range of labour and overhead costs and a "reasonable" manufacturer's profit. The FOB measure would remove distinctions between integrated and outsourced manufacture, which are impossible to justify in logic and which create a new layer of economic distortion. It would also remove any distinction between "The Factory" where the last process took place and other entities contributing to the value of the final export good. An FOB rule would assist manufacturers and would be much more consistent with the way in which business is required to operate today in response to competitive pressures. (sub. 20, p. 14)

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[12] With the services sector contributing around 60 per cent of global output (WTO 2003g), and more than 75 per cent of the total output of the Australian economy (McLachlan, Clark, and Monday 2002, ch. 3), RoO which take account of services would better reflect the regional content of goods entering the trans-Tasman trade.

[13] Another possible RoO which would reflect the full value of services and other non-factory local costs is a 'substantial business operations' test. This test, akin to the (non-preferential) origin requirement under the General Agreement on Trade in Services (GATS), is not considered feasible. Such a test would only require that a firm has a substantial business presence within the CER area. There would, for example, be no requirement for the firm to have undertaken a manufacturing process within the region. While an advantage of such a rule is that it recognises the contribution of services to regional content, it is not a satisfactory method of establishing substantial transformation in the sense generally applied in the formulation of RoO.

Since regional content is calculated differently for the factory cost and the TVBD methods, the current percentage threshold could not be applied automatically to the TVBD method and produce the same economic effect. For example, if the current CER RVC percentage threshold was maintained under a TVBD method, it would result in a significantly more liberal RoO than under the factory cost method (ie manufacturers would have greater flexibility to use inputs from non-member countries).

### *Disadvantages*

A problem that might arise with the TVBD method is the possibility that transfer pricing would artificially alter the fob value of goods or imported material inputs. Fisher & Paykel said that:

> The weakness of the TVBD method is that it can be easily manipulated by exporting structures being changed to vary the FOB value. For example, distribution and warranty costs in an export market might be 20% of the purchase price, and if paid for by the country of origin, the FOB will be higher and the threshold will be more easily achieved. (sub. 36, p. 3)

The TFIA also noted that the TVBD method is:

> … even more susceptible to manipulation and abuse than the current [factory cost] system. The TVBD also requires a new threshold to be determined and could cause companies considerable financial and resource costs to adapt to. (sub. 34, p. 4)

However, such valuation problems are not unique to this method and administrative procedures are in place to ensure that prices are not out of line with market levels.

More significantly, a change in the method of calculating regional value could involve significant transition costs (including the determination of an equivalent content threshold). Further, changing the method of calculation would not remove some key problems associated with the CER factory cost method — in particular, it would not reduce uncertainty for some producers arising from exchange rate and other price changes.

## Rely solely on a minimum regional value requirement

Another possible design change is the removal of any manufacture requirement, thereby determining origin solely by a RVC requirement, possibly using the TVBD method with a fob valuation of the good.

### *Advantages*

The advantages of moving from the factory cost method to the TVBD method were outlined above. Relying solely on a regional value test would have the added advantage

that the rule would be technologically neutral, as origin would not be dependent on any particular type of process occurring (eg an approved manufacturing process). For example, the refurbished yacht in the *Jolly O* case would be deemed to be of New Zealand origin, as around 60 per cent of its assessed value on entering Australia was added in New Zealand, even though it was found not to have undergone a 'manufacturing process' for the purpose of the determination of origin.

### *Disadvantages*

Although not a disadvantage in the economic sense, it is perhaps worth noting that transhipment would be a possibility under this approach (eg for items with low cost of manufacture relative to the cost of handling and transportation). That is, without an explicit requirement that a manufacturing process occur within the region (the conventional test of substantial transformation in RoO design), a good could satisfy origin requirements without undergoing such a process.

## Align treatment of allowable expenditure in Australia and New Zealand

Irrespective of other changes that might be made to RoO, the treatment of allowable expenditure should be consistent in Australia and New Zealand.

Currently, some significant differences in the implementation of the RoO are resulting in inconsistent treatment of goods depending on whether they are being imported into Australia or New Zealand. The differences of concern are:

- the method for calculating the percentage of local content for mixed origin materials; and
- the method for imputing the value of materials supplied to contractors free of charge (chapter 5).

With respect to the method for calculating the percentage of local content of mixed origin materials, the use by New Zealand authorities of the factory cost method excludes regional content that is covered by the TVBD method used by Australian authorities. The Australian method of calculation is more in keeping with the intent of the CER RVC threshold. It is also simpler to apply and has lower compliance and administration costs. One way of removing the inconsistency would be to align the New Zealand treatment with that used by Australia.

In relation to the method for imputing the value of materials supplied to contractors free of charge, the approach adopted by Australian authorities can result in high-value imported content being excluded from the factory cost calculations, whereas it would be included in

the New Zealand calculations. The Australian method would appear to be inconsistent with the intent of the CER RVC threshold. As noted by DITR:

> At present, under Australian law, much of the imported content going into the final process is disregarded where the last process is outsourced. This is recognised as a possible defect in our law and action is in train to examine changes. (sub. 16, p. 3)

One way of removing this problem, which would be consistent with CER principles, would be to align the Australian treatment with that used by New Zealand.

Australian Customs has advised that, in line with the Joint Ministerial Statement on RoO, the Customs Services of Australia and New Zealand have established a Joint Customs Committee:

> One of the tasks of the Committee is to ensure consistency in the administration of RoO. (sub. 32, p. 2)

The problem identified above by DITR should be addressed through the adoption of the 'principal manufacturer' (or the Commission's preferred 'principal firm') rule (see chapter 5), although such a change is yet to be implemented within Australia.

## 8.3 Change in tariff classification approach

A change to a CTC approach to origin determination is canvassed in a number of submissions. This would constitute a substantial shift from the regional value content model on which the current CER RoO are based. At its simplest, a CTC approach confers preferential treatment on a good classified to one Harmonized System (HS) item that is produced using imported inputs classified to different items. From this viewpoint, the method has a number of advantages. These arise from the fact that the HS is a well established, widely used and detailed classification of merchandise trade. In principle, the CTC requirement by itself would be relatively straightforward, known in advance, and not subject to 'interpretation' by either firms or government.

The HS tariff nomenclature, however, was not designed as a tool for conferring origin. As a result, the extent of transformation (value added) required will vary from item to item., In practice, the application of a CTC approach typically involves line-by-line tariff rules of varying complexity, supplemented for particular tariff items by sector-specific technical tests or RVC rules (which may in turn also provide for different methods of calculating content). These detailed 'rules' vary significantly between agreements using the broad CTC approach. Some examples are given in box 8.3.

### *Advantages*

In principle, the CTC method has features that could address the concerns of participants. An approach based on the application of a change in tariff classification, without secondary criteria:

- would not be influenced by cost or import content thresholds;
- would reduce compliance and administrative costs;
- would avoid the effect of price (or exchange rate) fluctuations on origin;[14]
- would result in increased certainty; and
- would require the keeping of minimal records for Customs audit purposes.

[14] However, a CTC rule itself might include a threshold couched in dollar terms. For example, under the proposed RoO for AUSFTA Chapter 64 'Footwear, Gaiters and the Like; Parts of Such Articles', item 6402.91(3) refers to 'A change to other footwear of subheading 6402.91, *valued not over $6.50/pair*, from any other heading outside subheading 6401 through 6405, provided there is a regional value content of not less than 35 per cent based on the build-up method and 45 per cent based on the build-down method (emphasis added). Such dollar value thresholds can have implications for the impact of RoO over time.

## Box 8.3 Examples of change in tariff classification rule

When a RoO is based on a CTC, each of the non-originating materials used in producing the goods must undergo the applicable classification change. This means that the non-originating materials are classified under one tariff provision before processing and classified under another once processing is complete.

### Example 1: Wooden furniture (HS 9403.50)

CTC rules can have a number of variants for the same product, within a single agreement.

*NAFTA rule of origin:*

A change to subheading 9403.10 through 9403.80 from any other chapter *OR*

A change to subheading 9403.10 through 9403.80 from subheading 9403.90, provided there is a regional value content (RVC) of not less than 60% where transaction value is used or 50% where the net cost method is used.

Thus, wooden furniture can qualify for NAFTA tariff preferences under one of two rules — a tariff shift or a combination of tariff shift and RVC requirement. The tariff shift rule requires that all non-originating inputs be classified outside HS chapter 94 (furniture & bedding). Since non-originating furniture parts are classified in chapter 94 (subheading 9304.90), the product may not qualify based on a tariff shift rule alone. The second rule has two components — a tariff shift and a RVC requirement. The tariff shift requirement is satisfied when the non-originating input (furniture parts) is classified in subheading 9403.90 as specified by the rule. The product must then meet its RVC requirement using either the transaction value method or the net cost method.

### Example 2: Passenger motor vehicles (HS 8703.10)

CTC rules can vary for the same product, between agreements involving the same or different member.

*NAFTA rule of origin*

A change to subheading 8703.10 from any other heading, provided there is a RVC of not less than 60 per cent where the transaction value [build-down] method is used; or 50 per cent where the net cost method is used.[15]

*Singapore–United States FTA rule of origin*

Change to heading 87.03 from any other heading provided there is a regional value content of not less than 30 per cent based on the transaction value [build-up] method.

*Australia–United States FTA rule of origin* (signed but not yet ratified)

A change to heading 87.01 through 87.05 from any heading provided there is a regional value content of not less than 50 per cent under a net cost [build-down] method.

*Thailand–Australia FTA rule of origin* (agreement yet to be signed)

Change to heading 87.03 from any other heading provided there is a regional value content of not less than 40 percent under a transaction value [build-down] method.

*Sources:* NAFTA; Singapore–United States FTA; Australia–United States FTA; Thailand–Australia FTA.

15 Since NAFTA came into force, the RVC threshold rate under the net cost method has increased progressively to the current rate of 62.5 per cent.

Participants who favour the CTC model indicated that they would not have difficulty in meeting the change in classification criteria because it delineates their inputs and outputs. For example, a number of apparel manufacturers said that, because their activity typically involves the transformation of fabric and other non-apparel material into finished garments — inputs and outputs covered by different HS items — it would be fairly straightforward to satisfy a CTC requirement. DITR said:

> … the CTC approach does have the advantage of giving certainty and is not inherently inferior to a broader transformation rule like the [CER] definition of manufacture. Indeed, … it has advantages provided it is used to provide a neutral description of the sort of transformation that occurs in industry when subject to MFN tariffs and rules. (sub. 28, pp. 4, 5)

Some participants suggested that a CTC test would also reduce their compliance costs. For example, Country Road submitted:

> The benefit of the [CTC] rule is its predictability in that decisions as to whether origin is conferred have already been made and written into the rule, so that its administration is far more mechanical than the current rule. (sub. 22, p. 11)

Australian Customs suggested that administration costs could be lower under CTC, because 'compliance is easier and quicker to establish':

> Customs administrations need to establish only the tariff classification of the finished product and the tariff classification of each imported material to check whether the necessary changes in tariff classification have occurred, and the manufacturers and Customs administrations do not need to be involved in detailed, time-consuming audits of manufacturing costs to ensure that goods claiming preference have the necessary local content. (sub. 24, p. 5)

It noted that:

> … the use of CTC would not be a financial or administrative burden on manufacturers because they already possess the information required for CTC RoO. (sub. 32, p. 3)

A further possible advantage of a change to a CTC model would be the alignment of CER RoO — at least in broad approach — with those in other PTAs. This reflects the fact that a CTC test is the most common primary criterion for determining origin across PTAs (chapter 3) and is intended to be the basis for the RoO under the AUSFTA and the Australia–Thailand FTA. DITR noted that, apart from CER, the only other significant PTA which does not rely on a CTC-based approach is the ASEAN agreement.

The Australian Industry Group advocated use of the RoO in the Singapore–United States Free Trade Agreement — based on CTC, with additional RVC requirements in some cases, because:

> … it has been tested in several FTAs over the last ten years. An important overarching rationale for revisiting the CER model is the potential to achieve some level of

harmonization between the various trade agreements that Australia has or will be party to. Harmonisation will simplify the increasingly complex world of trade rules in which Australian companies must operate. (sub. 29, p. 4)

### *Disadvantages*

For a mature trade agreement such as CER, where the RoO have been in place for 20 years, where much trade is already duty free and where remaining tariffs are scheduled to phase down to very low levels within a decade, the net gain from changing from RVC to CTC is unlikely to be large.

A change to a CTC rule would be a significant shift in the way Australian and New Zealand businesses and Customs determine origin in the CER — in particular, it would represent a significant and untested change in the codification of what constitutes manufacture. The costs of changing to a different RoO regime — even if small for many — would be incurred at a time when CER RoO are declining in relevance for most firms (chapters 2 and 4). It would necessarily involve some change-over costs for both firms and governments — for example, the considerable time and cost involved in developing the precise nature of the CTC rule for each category of goods. In the process, some goods which currently meet the CER origin requirements might lose preferential status under a CTC model.

The Australian Industry Group saw as a benefit of a CTC rule that it could be 'adapted to reflect the particular agricultural/industrial needs of the countries that are party to the agreement' (sub. 4, p. 6). In responding to the Commission's interim report, it said that:

> … [the] fact that origin determination is inconsistent across sectors is one of the assets of CTC based determination. This flexibility allows the ROO to cater to the particular process of manufacture of any given product: change at a six-digit level may represent significant transformation for some products, and almost none for others. Any given CTC test is able to appropriately reflect the specific manufacturing processes unique to any given product. (sub. 29, p. 4)

Several industry submissions argued that the RoO should be designed explicitly to take account of the specific needs of their industry. For example, the New Zealand Footwear Industry Association (sub. 8, p. 3) said that any CTC rule would need to be at least at the 4-digit level for its industry; while Country Road (sub. 22, p. 15) proposed a CTC at the 2-digit level. The Plastics and Chemicals Industries Association argued for a CTC method supplemented with a RVC test for selected products (as per Annex 3A of the United States–Singapore FTA (sub. 15, p. 8). PACIA added that the RoO in that FTA include a rule to the effect that, for plastics and chemicals, any good that is the result of a chemical reaction is declared to be a good of origin. PACIA supported this approach.

The use of different tariff classification changes for different industries (possibly supplemented by additional tests) can be problematic. As Palmeter (1994) noted, the major shortcoming of the CTC approach:

> … is the absence of any general principle [underlying] the selection of which specific tariff change is chosen to confer origin on particular articles. (p. 330)

As observed in chapter 3, the prevalence of special rules for sensitive sectors, while providing a benefit to those sectors, often serves to protect particular interests from the increased competition which a PTA seeks to generate, and which would otherwise provide the main benefits from such an agreement. Such a regime is likely to increase complexity and decrease transparency. In particular, the efficiency costs imposed by the typically product-specific nature of the CTC approach are not transparent or easily estimated. It is this lack of transparency which makes industry manipulation of the rule easier and often leads to RoO being used as a tool for industry protection (Aho 1992; Brenton 2003; Davis 1992; Palmeter 1993; and Stevenson 1997). Fisher & Paykel submitted:

> Use of the CTH [Change in Tariff Heading] approach, either separately or in conjunction with specific processes, will require in certain categories the development of a list of exceptions and variations. These lists are usually open to manipulation by interested parties and lack consistency and transparency in their application. F&PA agrees in principle with the CTH approach, but recognises that the detail likely to be involved undermines its suitability. For instance, the likelihood of a complex second tier test, lists of specific exceptions and variations, and the difficulty of accommodating the "parts of" definition, make this approach less attractive. (sub. 23, p. 6)

There can be other difficulties. For example, the extent of transformation involved in a change in tariff classification would vary between classification levels (eg 2-digit chapter, 4-digit heading or 6-digit sub-heading) and between categories in each level. It is also complicated by the existence of categories of 'other' related products at different levels within the classification. Thus, use of the tariff classification can result in somewhat arbitrary and inconsistent origin determinations across sectors.

Where the CTC approach involves the use of secondary criteria, such as RVC rules or technical tests, the method embodies added disadvantages, including those arising from:

- the limitations of the secondary criteria themselves, which may penalise efficiency improvements and technological change, and increase uncertainty and compliance costs;
- use of product-specific rules as industry protection measures, which can be facilitated by a lack of transparency about their formulation, and can disadvantage users and consumers of goods traded under these criteria; and
- the added complexity of multiple criteria and associated compliance costs for firms and Customs.

In order to keep abreast of new products and technological advances, the HS, upon which the CTC rules are based, must be updated regularly (WTO 2002; Brenton 2003). At present, the HS is revised every 5 years, with the last revision occurring in 2002. The lengthy period required to undertake research and agree on revisions, together with the sizeable gaps between updates, could disadvantage producers of goods incorporating technological or product innovations. The alternative, of changing the RoO, is also far from straightforward, as the background to the current study demonstrates.

Because of the detailed nature of the HS and the potential importance of the classification of trade to commercial outcomes, classification disputes can be an issue. Referring to the Canada–United States and NAFTA agreements, Palmeter (1994) argued that:

> Customs classification disputes are frequent; they have been a mainstay of the practice of customs lawyers for generations. (1994, p. 31)

Fisher & Paykel said there can be lengthy disputes over the classification of goods:

> The HCDC [Harmonized Commodity Description and Coding] system is large and complex and requires considerable technical expertise to interpret and apply. There is a considerable body of precedents to assist in this respect, both within the World Customs Organisation, and from other Customs administrations, but the inherent uncertainty in the interpretation of the Rules of Tariff Classification will disadvantage exporters. (sub. 23, p. 6)

A switch from RVC to a CTC-based method would also involve change-over costs. Some participants said they would be small. For example, DITR submitted that industry has:

> Through consultation over the US and Thai FTAs … developed a familiarity with the CTC method and has indicated broad support for this approach. (sub. 16, p. 7)

However, in the Commission's view, there would be significant costs in changing the system of RoO from RVC to a CTC-based method. Governments would need to consult with industry and negotiate CTC-based RoO acceptable to both sides. Even if the RoO were based on an existing template, extensive discussions would be needed to finalise the rules. Moreover, while a significant number of Australian firms may have become more familiar with the CTC RoO intended to be used in the agreements negotiated with the United States and with Thailand, New Zealand has no CTC-based agreements. Once such an agreement was in place, ongoing compliance and administration costs may be small for many firms. If the agreement involved supplementary RVC or other tests, however, such costs are likely to be as onerous as for the current RVC RoO.

The Winemakers' Federation of Australia said that, while it is actively involved in WTO negotiations where it is a strong supporter of the CTC approach:

> … we recognize the shortcomings of the harmonized tariff code system for this purpose. We also concur that the transaction costs from changing to this method would be significant. (sub. 26, p. 1)

Fisher & Paykel noted that the CTC method:

> … on its own will not provide a total solution and the second tier test could introduce complexities that would negate any perceived advantages over the ad valorem approach. … (sub. 23, p. 6)

The advantages of having multiple PTAs using the CTC method as a common basis for determining origin are severely reduced, or perhaps negated, by the use of quite different supplementary criteria across different agreements. These differences are illustrated in box 8.3.

Often the tests typically associated with use of the CTC rule negate many of its advantages and exacerbate its disadvantages. Indeed, Brenton (2003) argued that:

> … whilst in principle the change of tariff classification could provide for a simple uniform method of determining origin in practice instead of a general rule there are many individual rules and as such the determination of the rules of origin can be influenced by domestic industries in a way that reduces the impact on competition of preferential trade agreements. (p. 19)

For such reasons, the application of a CTC approach can be more complex than it first appears. Palmeter observed:

> With a tariff schedule not designed to facilitate origin determinations, perhaps no single [CTC] rule or principle is possible. (1993, p. 329)

The aspects of the CTC system that make it attractive to some in industry can be the same aspects that make it less desirable from the viewpoint of the community as a whole.

In summary, a change to a CTC rule would be a significant move in the way Australian and New Zealand businesses and the Customs Services determine origin in the CER. There is considerable doubt about whether the determination of what constitutes manufacture would be more rigorous than current procedures — some firms could be advantaged while others would be disadvantaged relative to their situation under the current arrangements. Furthermore, there is considerable evidence that the CTC method is easily manipulated to provide protection to sectional interests in a non-transparent manner and concern among some participants about such an outcome.

## 8.4 Rely only on a standard definition of manufacture

In the discussion of the RVC model above, one option for change involved utilising a standard definition of manufacture. In addition, interest in the CTC model indicates that a significant number of participants would see advantages in a model that:

- decouples the origin test from particular content tests;
- affords a high degree of certainty; and
- is administratively simple.

Taking into account these considerations, a further option would be to simplify the determination of origin under the CER to rely on a recognised definition of manufacture as a basis for a stand-alone approach to determining origin.

Under such an approach, CER origin would be conferred if the last manufacturing process was performed within either Australia or New Zealand. The requirement to meet the current 50 per cent threshold would be removed. If the processing in CER was sufficient for the final good to be considered a commercial good different from the goods which went into its production, it would be deemed to be of CER origin. Consequently, for some goods, this approach may represent a lower 'hurdle' than is posed by the current 50 per cent threshold.

Further, the requirement would appear to conform with the broad requirements in the Kyoto Convention (chapter 3). That convention laid down the general principle that the origin of goods should be determined by the last or final country where the good was substantially transformed — the 'substantial transformation criterion'. The definition of the 'substantial transformation criterion' under the Kyoto Convention states that the:

> … country of origin [is] the country in which the last substantial manufacturing or processing, deemed sufficient to give the commodity its essential character, has been carried out. (WCO 1975, Annex K, Chapter 1)

Comparison of this definition with the current CER or SAFTA definitions suggests that a manufacturing test, by itself, would satisfy the 'substantial transformation criterion'. Additional requirements, such as a RVC requirement, would appear to be more than what is required to establish origin under the Kyoto Convention and therefore would not need to be included in the simplified approach to determining origin.

In view of this commonality, it would appear appropriate to assess whether a simplified determination of origin could be adopted, using only a manufacturing requirement. Of the alternatives discussed earlier, the definition contained in the Customs Act (SAFTA definition) would appear to be preferred in the context of the CER (section 8.2).

In principle, relying solely on a manufacturing process requirement might meet some of the objectives which are sought by many who see disadvantages in the current RVC model.

### *Advantages*

The use of a manufacturing test to determine the place of substantial transformation would have a number of advantages.

- With no additional RVC or CTC requirement, RoO based on this test would minimise distortions to production and investment decisions. As long as a manufacturing process is undertaken within the region, the approach would not constrain decisions on the sourcing of inputs. Constraints on firms' choice of technology and organisation would also be minimal.
- Price movements (including exchange rate fluctuations) would not have an impact on origin determinations.
- Once it had been established that a good has been produced by a manufacturing activity, there would be no significant ongoing accounting, monitoring or evidentiary requirements for business. Verification and compliance monitoring by Customs would be relatively straightforward.
- Outsourcing (and commission and toll processing) would not be an issue — provided that such manufacturing activity is undertaken within the CER region, it would be treated no differently than any other manufacturing processing.
- It would conform with the international benchmark for RoO provided by the Kyoto Convention requirement for determining origin.
- There would be minimal scope for RoO to be used as a tool for industry protection (provided that product-specific supplementary criteria were not included).
- Because a manufacturing process is required to be undertaken, the risk of transhipment would not apply.

### *Disadvantages*

While the definition of manufacturing is well-established and understood (appendix C), its application as a stand-alone RoO would be novel. This would result in familiarisation and other change-over costs, at a time when CER RoO are declining in relevance. Those costs would be low if the manufacturing requirement used the current common law or SAFTA definition, simply because these approaches are already applied in the CER or agreements to which Australia and New Zealand are a party.

Relying solely on a manufacturing test would increase the relative importance of the definition of manufacture and the incentive for firms to try to exploit any loopholes and uncertainties.

Hence, the uncertainty caused by case-by-case assessments using either a general common law or legislated definition, which in practice is sometimes difficult to apply, would be a greater disadvantage than it would be when the definition is only used as one element of determining origin, as is currently the case in CER.

In practice, the incentive for firms to utilise any loopholes and uncertainties would be limited by the expected benefit — the value of the tariff concession — and the costs of utilising the relevant dispute resolution mechanisms. For the majority of goods engaged in trans-Tasman trade, this incentive would be relatively small, as most trade is subject to low tariffs, and any appeal would incur significant costs — including costs associated with the length of time to reach final judgment. However, for goods with above average tariffs — notably TCF — such costs might be justified.

## 8.5 Waivers

Some PTAs provide for waivers of RoO in specified conditions. Typically, this may occur for sectors which face low tariff barriers, or where the MFN rate is similar in member countries. For example, under the Integrated Sourcing Initiative (ISI) in the Singapore–United States FTA, certain information technology components and medical devices are not subject to RoO when shipped between the member countries.

However, a form of waiver could be used more generally — for example, as a waiver of the current CER regional value content test in specified circumstances.

As noted throughout this report, RoO are only needed where MFN tariffs differ — that is, where there is a risk of transhipment which would undermine the intent of the CER by providing duty free entry to products not originating in Australia or New Zealand. The incentive for firms to undertake transhipment occurs when they can import a non-CER good into the country with the lowest tariff (typically New Zealand) for transhipment duty free to the high tariff country (typically Australia).

Where the MFN rates for Australia and New Zealand are the same, there is no incentive to tranship and therefore no need for RoO. This is already the case in CER for the 40 per cent of tariff items which have a MFN tariff of zero in both countries.

Where MFN rates are not the same, but close (say, 5 per cent in one country and 7.5 per cent in the partner country), the incentive for transhipment is low or non-existent because of the cost of transport and handling across the Tasman. In other words, incurring the

additional costs associated with unloading goods in one country, performing some basic manufacturing process, reloading and transporting the goods across the Tasman is likely to be justified only if it results in the realisation of a sizeable reduction in the net duty paid. In CER, 44 per cent of tariff items have MFN rates that differ by 5 percentage points or less between the two countries.

These relatively narrow margins would provide a suitable basis for the application of a simple 'waiver' rule. This could require that only a 'manufacture' criterion would need to be met for duty free entry when the difference between the two countries' MFN tariff rates for particular products was small — say, 5 percentage points or less.

Underlying such a waiver approach is the presumption that the cost of transhipment would make it unlikely that goods would be transhipped where the MFN tariff difference is 5 percentage points or less. With transport costs (not including costs associated with off-loading, re-loading and local transport and handling) between the two countries averaging around 5 per cent of the value of shipments (about 3 to 4 per cent[16] for textiles, clothing and footwear), this would appear to be the usual case.

Fisher & Paykel said that 5 per cent 'is a fair estimation' of average transhipment costs between Australia and New Zealand and 'can therefore be used to set the differential threshold' (sub. 36, p. 2), while Cambridge Clothing said its trans-Tasman freight costs amount to 3.1 per cent of the fis value[17] of its products (sub. 35, p. 1). In contrast, the Australian Industry Group said that to assume that shipping costs outweigh the attractiveness of transhipment 'is a dangerous general assumption':

> Averages, by their very nature, do not take account of the highest (or lowest) expression of an equation. What about the goods that are less expensive to ship than 5 percent of the FOB value of the goods? Is trans-shipment in those cases more likely? (sub. 29, p. 3)

The TFIA took a similar view, noting that the assumption is a 'poor basis' on which to make a recommendation. It added that:

> For bulk cargos — as the Commission has noted — it is possible to achieve exceptionally low rates of freight costs. (sub. 34, p. 6)

Clearly, some products will cost more and others less to ship across the Tasman than the average figures shown in Customs documents indicate. Trans-Tasman transport costs commonly average around 3 to 6 per cent of the value for duty (fob value) for many

16 There is significant variability in these costs between activities in TCF. At the industry level, transport costs range between 3 per cent and 7 per cent of the value of shipments.

17 Free into store — where the seller has responsibility for all costs as in cif plus customs duty, landing costs and all transport charges delivered into the buyer's store. As these costs can be significant, the trans-Tasman freight costs would represent a larger portion of imports valued on a 'value for duty' basis.

ANZSIC 2-digit industries. However, they can be as high as 13 per cent for 'non-metallic mineral products' and as low as 1 per cent for 'other vehicles' and can vary markedly within 2-digit industries. For products for which bulk shipping can be used (and is available at the right time), costs may be lower than 5 per cent. On the other hand, products such as certain apparel may for commercial reasons (eg associated with 'just-in-time' delivery) use more costly airfreight services. In addition, goods are subject to storage and handling costs and a manufacturing process before transport across the Tasman, as well as storage, handling and distribution costs after transport. These additional costs would be incurred for goods manufactured in Australia or New Zealand for export to the CER partner and for goods imported into Australia or New Zealand for re-export (or transhipment) to the CER partner. The available estimates of trans-Tasman freight costs therefore represent a lower bound to the total cost of shipment.

A waiver could also be cast in terms of tariff levels, rather than tariff differences. However, such an approach would not take into account the likelihood that a producer in one member country would take advantage of the tariff on finished goods in that country and sell at a higher price than would otherwise be possible. The tariff-assisted price in the home market then also would be likely to form the basis of the pricing of exports to the partner country. This would mean that its competitive position in the partner country would be determined by the extent to which the partner country tariff is above or below the tariff in the home market. In other words, where the tariff in the partner country is above that in the home country, the ostensible competitive benefit to the exporter of duty free entry under a waiver would be offset by the price-raising effects of the protective tariff in its own country. Thus, in this case, it is the difference in tariffs on outputs between the home-country and PTA partner markets, rather than the tariff level, that is the relevant point of comparison for the application of the waiver.

An approach based on the level of tariff assistance was canvassed by the TFIA in the context of interim recommendations for longer-term change presented in the Commission's interim report — namely, the elimination of the regional content threshold with only the 'principal firm' manufacturing test being applied and the alignment of non-zero tariff rates in Australia and New Zealand. The TFIA argued that:

> If the Commission intends to retain these [longer-term] recommendations in its final report the TFIA would propose that it be changed to allow the RVC requirement to be removed once MFN tariffs on a product or product range have reached 5% in both Australia and New Zealand leaving only the 'principal firm' rule (with SAFTA changes) as the sole means for determining preferential entry. (sub. 34, p. 9)

Under this approach, the RVC requirement would be removed as tariffs for 'products or product lines' in both countries reached the 5 per cent level in accordance with scheduled tariff reduction programs. This suggestion is equivalent to a 'waiver' based on tariff levels rather than differences. While a tariff level waiver invoked at low tariff levels — 5 per cent

in this example —would have some initial impact on CER trade and production, it would defer addressing problems with the current RoO for many years.

For example, in the areas where problems with RoO have been most evident — TCF in particular — a tariff level waiver could have no major impact until 2010 at the earliest, when Australian rates for cotton sheeting, woven fabrics, carpets, footwear and parts, sleeping bags and table linen are scheduled to fall to 5 per cent. (New Zealand has not yet decided its tariff rates beyond 2009.) Passenger motor vehicles and parts are not scheduled to reach this level in Australia until 2010. For clothing, a major item of concern during this study, removal of the regional content requirement (while leaving the requirement that the good be manufactured in Australia or New Zealand) could not apply before 2015 and only if and when New Zealand reduced its tariffs on the same goods to 5 per cent.[18]

Deferring the liberalisation of the RoO in this way would not be in accord with the trade-enhancing intent of CER. It would severely limit the extent to which changes address problems with the current CER RoO. In the Commission's view, a key objective ought to be to reduce that restrictiveness, which is increasingly leading to distortions in production and trade, and requiring many firms to continue to face significant compliance costs.

### *Advantages*

Under the waiver option, no specified level of regional value content would be required for items where the MFN tariff difference was 5 percentage points or less. A process of 'manufacture' within CER would be sufficient to confer origin. This rule would have several significant advantages.

It would significantly reduce compliance and administration costs. For eligible products, detailed costings would no longer need to be compiled and kept (for years) to demonstrate origin.

Impediments to the efficient sourcing of inputs would be reduced for goods meeting the waiver criteria. Importantly, it would allow the choice of inputs for the goods to be dictated by the needs of consumers, and not by the requirements of the RoO. Some producers of certain product lines would be likely to change their choice of inputs. For instance, they may elect to purchase more expensive but more preferred inputs and attempt to compete in other market segments. For example, Rembrandt Suits noted that, during periods when the New Zealand dollar appreciated, it was able (temporarily) to purchase and offer to the market higher quality European cloths and still meet the local content requirement (sub. 38, p. 2).

[18] Some other goods would be subject to a tariff level waiver in July 2008, when New Zealand intends to reduce some rates to 5 per cent.

Similarly, for some firms, the waiver would, reduce the impediments which the RoO can impose on technological and organisational change, and resultant productivity gains.

A waiver would be consistent with the trade-enhancing objectives of the CER insofar as it would increase export opportunities and market access for both Australia and New Zealand. It would also cover a large proportion of traded items because of the similarity of the Australian and New Zealand tariffs. As a result, the proportion of current trans-Tasman trade subject to the CER RVC test would be about 12 per cent, rather than 47 per cent under the present RoO. By 2005, following further scheduled reductions in Australian TCF tariffs, most trans-Tasman trade would need only satisfy the requirement that some manufacturing took place in the originating (CER partner) country. Australian Customs considered:

> … that the implementation [of the waiver] will encourage trade between the two countries and will lessen the administrative and compliance burden on manufacturers and Customs. (sub. 32, p. 2)

At current duty levels, such a waiver approach would be likely to have a positive, but modest, impact on trans-Tasman trade. As tariffs continue to fall, this positive impact would be reinforced as more products become eligible for duty free entry.

### *Disadvantages*

Because it would involve some adaptation of current procedures, there would be some change-over costs as firms and administrative agencies familiarised themselves with the new procedures. Given the simplicity of the waiver criteria, these costs would be small.

Much of the argument against the waiver proposal derives from a concern about the possible impact of freer CER trade. Commonly, differences in tariffs on intermediate inputs and the advantage of duty drawback for exporters relative to producers selling in their domestic market were raised as reasons for not implementing a waiver. Some argued that tariffs, and in some cases schedules for the future course of tariff reductions, have been set in place and that any change to the RoO would undermine the protective effect of those arrangements.

The Australian Industry Group saw the waiver proposal as ‘fundamentally flawed’:

> … as it is not a robust methodology for assessing local content. This essentially is an option based on not having a system. It does not take into account all the factors which impact the trade costing equation. The impact of the Duty-Drawback Schemes in both countries is a good example of how the waiver option fails to accurately calculate local costs. TCF companies in either country would face unfair competition in their domestic markets, with imports potentially priced lower than domestic goods as they would be eligible for duty-drawback, whereas domestically manufactured and sold goods are not. (sub. 29, pp. 2–3)

The implications of different tariffs on inputs — the intermediate goods problem — are discussed in chapter 5.

The TFIA also argued against change to the RoO. It cautioned that:

> … the Commission must accept that several companies will cease their operations or significantly scale back staff if ways of manipulating the waiver system are found that allows near completed products from non-CER countries to enter as preferential goods. (sub. 34, p. 7)

It said that:

> … the TFIA estimates that under current tariff levels around 60% of TCF items at the eight digit harmonised tariff code level would fall under the waiver. Factoring in the changes to tariff rates due to occur in Australia in 2005 and New Zealand in 2006 this share would move to around 84%. By 2009 the year where tariffs diverge significantly only 45% of products would be subject to the waiver. A rough estimate however of the situation post 2010 would suggest that more than 95% [assuming that the 2006 review of New Zealand tariffs does not recommend that tariffs be increased] of TCF tariff items would be under the waiver despite many still having significant tariffs to the non-CER world. (sub. 34, p. 6)

If the waiver were to come into effect after the January 2005 tariff reductions in Australia, items such as some carpets and footwear would not be subject to it until 2007. (In contrast, if it were to operate before then, these items would be subject to it immediately.) A waiver would cover nearly all TCF trade by 2010.

These concerns cut to the heart of what the RoO and the CER are designed to do. The CER is a PTA — it seeks to remove barriers to trade between Australia and New Zealand and create export opportunities for both countries. The Commission has demonstrated that the RoO that underpin the CER have themselves become restrictive and are undermining the objective of expanding free trade between the two countries. Hence the Commission's proposals to simplify and liberalise the RoO. Each CER country's tariffs against the rest of the world would remain untouched by the waiver option. The integrity of the protective tariff is not the issue.

FINDING

*Because certain problems arise with each method commonly used to determine origin, there is no ideal solution to current concerns. Moreover, different RoO can result in different determinations of origin for a particular product. Consequently, any proposed changes will involve some compromises.*

## 8.6 Tariff-based options

There are some possible tariff-based options for change that may address some of the problems identified with CER RoO. These include:

- conversion of RoO to equivalent tariffs; and
- harmonising Australian and New Zealand tariffs.

The preceding chapters have shown that the costs imposed by RoO can act as an impediment to trade. Some of these costs are unavoidable, but it is also possible for parties to a PTA to use certain RoO as implicit non-tariff barriers to trade. This can be seen in the inclusion in both the NAFTA and the draft AUSFTA of yarn forward rules which effectively bar trade in textile goods that fail to have their complete production process located within member countries.

It is possible when developing a PTA to replicate the protection afforded to certain sensitive sectors by restrictive RoO in the form of tariffs which still remain between the partners even though tariffs for other goods have been reduced or removed. While this is not an ideal option, on transparency grounds it would be preferred to the implicit protection afforded by restrictive RoO.[19]

The option of converting RoO to equivalent tariffs is not considered feasible for the CER. At a time when CER RoO are declining in relevance due to tariff reductions, this approach would involve raising concessional tariffs from the current level of zero — a measure contrary to the provisions of the CER. In addition, there would be difficulties in determining tariff equivalents to the current RoO.

### Harmonise tariffs

RoO are only relevant when the MFN tariff rates differ between member economies. Hence, if the non-CER MFN rates between Australia and New Zealand were harmonised, there would be no need for RoO, as transhipment would not occur. Country Road (sub. 22, p. 8) noted that tariff harmonisation is an option for change.

This option may be feasible, given Australia's and New Zealand's scheduled tariff liberalisation programs — for example, by 2009 the vast majority of goods imported into Australia and New Zealand might well face no more than a 5 per cent tariff. It is likely that it would involve minimal transition costs.

[19] A variant of this could be to exempt sensitive sectors from the PTA. That is, trade between member countries would occur at the MFN tariff rate.

A harmonised tariff schedule would conform with the goals of the CER. Under this option, the elimination of the RoO would remove all the associated compliance and administration costs. It would also remove all existing impediments to trade, the sourcing of inputs, organisational and technological innovation, and responses to changes in consumer tastes. In short, this is the one option which would result in a favourable assessment against all the design principles outlined in chapter 7.

# 9 The Commission's proposals

The Commission has been asked to propose changes, including design or model changes, to ensure that the RoO continue to promote the goals of the CER. The Commission's proposals seek to remove impediments to trans-Tasman trade and thereby to increase access by Australian and New Zealand exporters to each other's markets.

The case for change depends upon evidence of impediments to trade and related problems in the current arrangements, as well as the capacity of various options for change to address those shortcomings. In this context, any change in the rules needs to be cognisant of the level of Australian and New Zealand tariffs, current differences between them and expected future tariff changes. These factors determine the likely effects of RoO and the period during which origin rules will continue to be relevant to CER trade.

Currently, about 40 per cent of tariff items are already accorded a MFN duty of zero by both Australia and New Zealand, making RoO irrelevant for them. For a further 44 per cent of tariff items, the difference between the Australian and New Zealand MFN tariff rates is 5 per cent or less. RoO are not a major consideration for trade in these items. Indeed, with a few exceptions, it seems likely that scheduled tariff reductions in both countries will result in little or no difference in MFN rates on either side of the Tasman within a decade.

Against this background, this chapter initially notes the increasingly restrictive nature of the RoO since their inception, summarises scheduled tariff reductions in both countries and then presents recommendations for change which take account of these developments.

## 9.1 CER RoO have become unduly restrictive

The current RoO were introduced in 1983 when industry conditions were different and border protection much more stringent, but have changed little since. Some aspects of their design are now dated, and they are imposing unnecessary costs on producers within the CER region (chapters 5 and 6).

The problems stemming from CER RoO cut across a range of activities and have widespread effects. The RoO encourage some firms to make inefficient purchasing

decisions and can penalise efforts to take advantage of technological and organisational innovation and to export globally. The shortcomings have arisen primarily because of changes in the way production takes place, with much of it now globally fragmented as companies seek to take advantage of specialisation in the supply of intermediate goods.

These developments have made it harder for firms to meet the RoO, notwithstanding the fact that the primary place of manufacture may still be within the CER region and that the traded goods contain significant local content. In this environment, the RoO are providing incentives for some firms to pursue costly and inefficient behaviour and are not operating in accord with the trade-liberalising objective of CER. In fact, they are now impeding long-standing efforts to make the Australian and New Zealand economies more open and more competitive internationally.

## 9.2 The tariff environment is changing

As noted in chapter 2, the current debates about the CER RoO are taking place against a backdrop of declining tariffs in both countries and the intention that this will continue.

In Australia's case, more than 47 per cent of tariff items now have a MFN rate of zero and a further 42 per cent have rates of 5 per cent or less. In the two sectors for which tariffs exceed 5 per cent:

- tariffs in the PMV sector are scheduled to fall from 15 per cent to 10 per cent in 2005 and to 5 per cent in 2010; and
- the highest TCF tariffs — for apparel and some finished textiles — will be reduced to 17.5 per cent in January 2005, to 10 per cent in 2010 and to 5 per cent in 2015. Tariffs on cotton sheeting, woven fabrics, carpets and footwear will be reduced to 10 per cent in January 2005 and to 5 per cent in 2010. For other TCF items, tariffs will fall to 7.5 per cent or 5 per cent in January 2005, and any still above 5 per cent will fall to that level in 2010 (table 2.2).

In New Zealand's case, about 65 per cent of tariff items are now subject to a zero rate and 28 per cent have rates of around 5 per cent or less.[1] High tariff rates — those between 17 per cent and 19 per cent, which apply largely to clothing, footwear and carpets — will be

[1] Because the Australian and New Zealand tariff rates' schedules are not aligned, items may be subject to a zero rate in Australia and non-zero rate in New Zealand (and vice versa). The incidence of items in New Zealand subject to a zero tariff rate is increased by permanent tariff concessions granted under commercial tariff concessions orders, under which MFN imports can be granted duty free entry provided that no production is determined to occur in New Zealand. Once granted, the concession is permanent.

reduced progressively from July 2006 to 10 per cent by July 2009. Tariffs on all other goods with a MFN rate above 5 per cent will be reduced to 5 per cent by July 2008.

FINDING

*As tariffs in Australia and New Zealand continue to fall, it is possible that there will be no need for CER RoO in 5 to 10 years.*

## 9.3 Where to from here?

By the standards of other PTAs (most of which use the CTC method for determining origin), the CER RoO are relatively 'clean' — that is, free of deliberately restrictive rules. It could thus be argued that no changes should be made to the current RoO. This would be a viable approach if it were judged that the current problems were relatively small and/or that the costs of proposed changes would be large. The Commission does not consider this to be the case. It considers that there is a clear case to respond to the problems discussed in this report and liberalise the RoO, in line with the goals of CER, particularly the intention to remove barriers to trans-Tasman trade.

Such an approach would also be consistent with recent statements by the Australian and New Zealand Governments, which have committed both countries to move towards a single economic market (with an agenda that also includes business law, taxation, the regulation of securities and the reduction of compliance costs and regulatory barriers in general). To this end, the Prime Ministers recently announced a program of work to develop a single trans-Tasman economic market (Howard 2004).

As outlined earlier, there is no ideal solution to the current problems. There is no perfect RoO and significant problems can arise with any RoO method chosen, simply because RoO seek to attribute a single origin to goods which are commonly produced using inputs obtained around the world. Moreover, different RoO can result in different determinations of origin for a particular product and generate different levels of compliance costs.

Non-discriminatory unilateral trade liberalisation, or liberalisation in accordance with MFN principles, would avoid this issue. However, within the relatively narrow focus of the present study, any proposed changes will involve some compromises. This is similar to the effects of policy changes in other areas of the economy — inevitably, some firms and sectors benefit, while some are made worse off. In these circumstances, policymakers need to identify the options that yield the greatest net benefit. In the case of CER RoO, possible changes range from refinements of existing procedures to more fundamental design or model changes.

FINDING

*Consistent with the objectives of the CER Agreement, options for change should aim to facilitate a more open trans-Tasman market by reducing the trade restrictiveness which has developed in the existing RoO and the regulatory burden which they impose.*

To guide the assessment of options for change, some design principles were proposed in chapter 7 and possible changes to CER RoO were assessed in chapter 8. The following discussion draws on that material.

## Adopt a different model for CER RoO?

One option for change would be to adopt an alternative framework for the determination of origin in CER by changing to a CTC-based method, which is widely used in PTAs around the world.

During the course of this study, there was support for a shift to the CTC model. The main support came from some clothing manufacturers, Australian plastics and chemicals participants and others who seek the certainty that this model would appear to provide for their CER-based activities. Australia's DITR and the New Zealand Government agencies also saw some advantages in this method.

In principle, the CTC method can be simple and clear for many products. It has intuitive appeal and is the most common model in PTAs involving the European Union and the United States. However, its implementation is fraught with problems. As explained in chapter 8, the classification on which it is based, the Harmonized System, was designed for the presentation of trade statistics, not the identification of the origin of goods. Because the extent of transformation involved in a change in tariff classification varies greatly between headings, it would provide inconsistent origin determinations across sectors of production. Furthermore, the CTC method itself is typically applied at different heading levels in the tariff classification, further adding to inconsistencies in the determination of origin. Consequently, the CTC method alone does not provide a genuine test of what constitutes manufacture and as such is not a consistent and reliable test of 'substantial transformation'. The classification can also be slow to adapt to changes in technology, as the Harmonized System is only updated infrequently.

Most importantly, however, its implementation involves detailed industry-by-industry origin rules and typically includes the use of secondary criteria, such as sector-specific RVC rules and technical tests (chapter 8). These require time-consuming and costly negotiations — between governments and industries — and can be subject to manipulation

to provide sectoral assistance with limited transparency. Indeed, as experience with PTAs based on the CTC method shows, RoO negotiators are likely to be concerned primarily with ascertaining what industries in their country are prepared to accept, rather than with achieving outcomes more likely to maximise the welfare gains for the community as a whole. Thus, exceptions and special provisions which are a feature of such agreements tend to be trade-restricting rather than trade-liberalising.

In short, implementation of the CTC model usually raises problems. In particular, it is very difficult to insulate from protectionist pressures. Its adoption could hinder the liberalisation of CER trade and lead to adverse resource allocation effects of a kind that the search for a better CER RoO should be trying to avoid.

A switch from the current RoO to a CTC basis also would involve some costs. It would certainly involve considerable transition costs for government and business. Moreover, some products which satisfy current CER RoO requirements may no longer be considered as goods of Australian or New Zealand origin and could be denied duty-free access under CER. On the other hand, some goods not satisfying current CER RoO requirements may well satisfy the requirements of a CTC-based system and qualify for duty free access. Were this situation to arise, additional negotiations could be required, thereby adding to transition costs.

To date, all of Australia's and New Zealand's PTAs use RoO which are broadly the same as those in the CER. However, Australia's recently negotiated agreements with the United States and Thailand are intended to operate on the basis of CTC. This might suggest that there would be benefits from also switching the CER to a CTC method. However, both Australia and New Zealand will still be party to other agreements — with Singapore, among others — based on a manufacturing and RVC requirement. Thus, a change to a CTC model would not eliminate multiple RoO in Australia's PTAs.

Moreover, CTC-based rules in different agreements are not formulated in the same way. While the broad principles underlying CTC do not change materially between PTAs, their detailed rules — in particular, as shown in chapter 8, even the rules applying to a single tariff item — can vary substantially. On a practical level, this undermines (or perhaps even eliminates) the theoretical advantage of having RoO based on the same basic design principle.

FINDING

*Adoption of the CTC model in non-CER agreements has been accompanied by substantial differences in origin rules, particularly for so-called 'sensitive' sectors.*

FINDING

*Achievement of similar origin rules is likely to become increasingly difficult as Australia and New Zealand engage in separate, and sometimes overlapping, PTAs. A multiplicity of RoO raises transactions costs and increases the likelihood of distortions in, and restrictions on, trade.*

Given the substantial reductions in Australian and New Zealand tariffs over the past two decades, the CER Agreement is now in a mature stage. Importers and exporters are accustomed to the existing CER RoO and the origin determinations that they provide. A model change would lead to implementation costs for them, particularly during the early 'learning' phase. For such reasons, and because of the shortcomings of the CTC method noted above, it is most unlikely that there would be net benefits from changing to a completely different model of RoO.

FINDING

*The CER Agreement is mature. A very high proportion of trans-Tasman trade now takes place duty free. The costs of changing to a different model for determining origin would be difficult to justify.*

RECOMMENDATION 1

***The basic form of the CER RoO should remain unchanged. The change in tariff classification (CTC) model should not be used for origin determination under the CER.***

The remainder of this chapter examines changes to the current RoO which would address the adverse economic consequences and regulatory burden discussed in this report.

## Proposals involving relatively minor changes to the current RoO

A number of relatively minor changes could be made to address some of the day-to-day shortcomings of the current CER RoO. (A more extensive discussion of the advantages and disadvantages of a range of options is contained in chapter 8.)

### *Change 'last place of manufacture' requirement*

In its interim report, the Commission considered that the most important of these relatively minor changes would be to change the 'last place of manufacture' requirement to one based on the 'principal firm' (broadly similar to that contained in the Singapore–Australia agreement). Defining the firm to be the producer that performs, or has performed on its behalf, the last process of manufacture within CER would accommodate the outsourcing arrangements that are now commonplace in business. It would reduce the costs and confusion caused by current arrangements, improve resource use and help to facilitate organisational and technical change. However, to the extent that trade increases, some firms might face increased competitive pressures. On the other hand, the change would benefit sub-contractors, exporters and consumers in Australia and New Zealand.

As a consequence of the activities of the officials' review group, Australia and New Zealand have now agreed to use the concept of the 'principal manufacturer' when ascertaining CER origin (chapter 5). The Commission sees this as a major improvement, but recommends that this concept be broadened to refer instead to the 'principal firm'. This would explicitly allow for cases where the firm organising the manufacture is not itself a manufacturer (chapter 8).

### *Adopt the SAFTA definition of manufacture*

As part of the standardisation of definitions, the Commission considers that there would be merit in adopting a standard definition of 'manufacture'. It favours the definition contained in section 153UA of the *Customs Act 1901* for the purposes of the Singapore–Australia Free Trade Agreement. This definition of what constitutes manufacture is based on the concept of substantial transformation and conforms with the common understanding of manufacture established in case law. While other approaches to defining manufacture were considered, the SAFTA definition has the additional advantage of already being in place in Australian legislation, and can be applied relatively easily to CER.

Adoption of the SAFTA definition also received support from a range of participants and was clearly preferred over an approach based on the Australian and New Zealand Standard Industrial Classification (ANZSIC) which was canvassed by the Commission in its interim report.

### *Align definitions and practices in Australia and New Zealand*

A second change worth implementing, irrespective of other developments, would be to align the treatment of eligible costs and other practices in Australia and New Zealand in order to achieve a single set of rules and practices applied in a uniform manner.

Differences in the legal and administrative systems between the two countries are likely to preclude precise alignment of legislation, regulation and Customs guidance manuals in all cases. In view of this, the wording used in legal instruments and in advice to traders should be as common as practicable. To this end, formal consultation processes are important and might need to be enhanced.

Australian Customs advised that, following the *Joint Ministerial Statement on Rules of Origin* issued at the 2003 Trade Ministers Forum, the Customs Services of Australia and New Zealand have established a Joint Customs Committee to ensure, among other things, consistency in the administration of RoO (sub. 32, p. 2). The Commission considers that, for whilever CER or related rules apply to trans-Tasman trade, it would be appropriate to maintain such a committee or working group to ensure that the rules are consistent and up-to-date.

RECOMMENDATION 2

***The following changes should be made to address day-to-day shortcomings of the current CER RoO.***

- ***The 'last place of manufacture' requirement be replaced with one based on the 'principal firm', defined as the firm that performs, or has performed on its behalf, the last process of manufacture in the CER region.***
- ***A standard definition of manufacturing — that contained in the Singapore–Australia Free Trade Agreement (ie section 153UA of the Australian Customs Act 1901) — be adopted.***
- ***The valuation and coverage of eligible costs in Australia and New Zealand be aligned to achieve a single set of rules implemented according to uniform practices.***
- ***Legislation, regulations and Customs guidance manuals in Australia and New Zealand be aligned as far as practicable.***

## Options involving more substantial change

The main options considered by the Commission to address concerns about the current RoO and to reduce its regulatory burden within the existing CER RoO framework are to:

- reduce the current regional value content threshold; or

- adopt a 'waiver' under which trans-Tasman trade in goods subject to a specified MFN tariff differential between Australia and New Zealand would be duty free within CER, provided that they were manufactured in Australia or New Zealand.

### *Reduce the current regional value content threshold*

To address some of the concerns of firms seeking more liberal RoO, the officials' group has already recommended that certain imported intermediate inputs be excluded from the calculation of factory cost (chapter 8). This is tantamount to a reduction in the RVC threshold for selected firms — that is, firms using the nominated imported inputs. The officials' proposal would benefit these firms, but be of little relevance to others and would be unlikely to lower administration and compliance costs. It would also depart from the non-discriminatory character of the current CER RoO. Therefore, while the Commission recognises the liberalising intent of the change, it considers that it would be more appropriate to reduce the present 50 per cent RVC threshold applying to all firms, thereby maintaining the non-discriminatory character of CER RoO. Such a step would improve efficiency and reduce identified impediments to organisational and technical change. It would address some of the problems identified in this report, although it would not overcome problems stemming from the manner in which the threshold is calculated or the information burden associated with local content tests.

Choosing the 'right' change in the threshold is difficult. Participants favouring liberalisation variously suggested levels ranging between 40 per cent and 25 per cent. In the Singapore–New Zealand trade agreement, the RVC threshold is 40 per cent. In SAFTA, while a threshold of 50 per cent applies generally, a 30 per cent threshold applies to some items — mainly electronic goods.

The timing of such reductions to the threshold also needs consideration. It would be possible to reduce the threshold in successive small steps in line with scheduled reductions in tariffs. However, because Australian and New Zealand tariffs are generally low and broadly aligned, successive small reductions in the threshold are unlikely to be warranted to reduce adjustment pressures on Australian and New Zealand firms. Small adjustments might also raise compliance and administration costs compared with one or two larger reductions in the RVC threshold.

If this option were pursued, the Commission considers that an initial reduction to 40 per cent in a single step would be appropriate, with a further reduction to 30 per cent in 2010 when Australian and New Zealand tariffs are lower. At that time, under recently announced tariff reduction schedules, no tariffs in either country should exceed 10 per cent.

This proposal would have some immediate benefits for those firms whose CER exports are at or near the current 50 per cent threshold. They would, for example, have more room to cope with exchange rate and input cost changes — a clear problem under current arrangements. However, as several participants pointed out, the problems identified in this report would eventually re-emerge at any lower threshold.

While this proposal would not suit all those engaged in trans-Tasman trade, it would be expected to facilitate a material improvement in efficiency and reduce constraints on firms' production and marketing activities (chapter 8). Exporters and consumers should benefit.

As noted in this report, the TCF sector appears to be most affected by the current RoO and, in all probability, would be the most affected by their liberalisation. However, the impact would be mixed. While some Australian firms would experience greater competition from New Zealand exporters, others would benefit from increased export opportunities.

FINDING

*A reduction of the regional value content threshold from 50 per cent to 40 per cent immediately, with a further reduction to 30 per cent in 2010, would help to address problems associated with the current RoO and to liberalise CER trade.*

### *Implement a 'waiver' model*

While a specific RVC content test, in addition to a manufacturing test, are requirements of the CER RoO, firms will still incur the compliance costs of the RoO and the Customs Services are still required to administer the rules. In addition, as mentioned, firms purchasing and organisational decisions will still be constrained.

A 'waiver' rule, as discussed in chapter 8, could address these problems. It would require that, where the difference between the two countries' MFN tariff rates for particular products is 5 percentage points or less, only the requirement that the good be manufactured in Australia or New Zealand (as per recommendation 2) would need to be met for duty free entry. No specified level of local content would be required. Where the difference between Australian and New Zealand MFN tariffs is small, the risk of transhipment of goods with low regional content is minimal because of significant transport and handling costs (chapter 8).

From the beginning of 2005, trans-Tasman trade in clothing, which is subject to above average MFN tariffs, would meet the waiver rule in January 2005 as scheduled tariff reductions take place. At that time, the percentage of trans-Tasman trade still subject to the CER content test could be around 8 per cent compared with under 50 per cent in recent

years (figures 2.7 and 2.8).[2] Products such as carpets and footwear would not be affected until July 2007 as the tariff difference will be greater than 5 percentage points until then. After 2007, virtually all trans-Tasman trade would need only to satisfy the requirement that the good had been manufactured in the originating (CER partner) country as per recommendation 2. Passenger motor vehicles, components and replacement parts would become subject to the waiver from January 2010 when Australian tariffs are phased down from 10 to 5 per cent.[3]

Once goods are made subject to the waiver, they should not revert to the RVC rule in the event of a future divergence of tariffs. For example, the waiver would first apply to clothing in 2005, but during 2009 the tariff difference is scheduled to increase to 7.5 percentage points for that year only (table 2.2). Because of the small and temporary nature of the difference, the likelihood of significant changes in patterns of production and sales would be small. Accordingly, little would be gained by reverting to the RVC rule for that short period. Based on current tariff reduction programs, it appears most unlikely that there would be a difference of greater than 5 percentage points between any Australian and New Zealand tariff items from 2010 onwards.

Liberalisation of RoO by way of a waiver would benefit user industries and consumers in both Australia and New Zealand. It would reduce the constraints imposed by the present RoO on firms' capacity to respond to technological and other changes in their operating environment. As tariffs continue to fall, the waiver could result in increased trade in goods originating in Australia and New Zealand. It would provide some new opportunities for export-oriented firms and for new exports. Some may change their product mix or expand production to compete in different segments of the market. Firms that have been discouraged from exporting because of the CER regional content requirements might find it attractive to enter the trans-Tasman market for the first time.

Some firms, however, including some in the TCF sector, would face greater competition and consequent adjustment pressures. This might be the case, for example, if any firms that now just fail the RoO test and pay the full MFN tariff were to obtain duty free entry into the other CER market under the waiver.

A material benefit of the waiver option for firms and Customs authorities in both countries would be significant savings in compliance and administration costs. Producers of any

[2] Using data from the early 2000s suggests that up to 12 per cent of trans-Tasman trade was in items for which the difference was above 5 percentage points. Since then, some Australian tariffs have been reduced and major items such as clothing are scheduled to fall within the scope of the waiver in January 2005.

[3] It should be noted that, under the waiver, restrictions on the importation of second hand vehicles (scheme) and Australian and New Zealand design requirements would still apply.

goods, having met the manufacturing requirement, would be freed from the compliance and paperwork demands associated with establishing that the CER regional content threshold had been reached. Customs Services would not need to monitor or audit such shipments for CER content.

The Commission views both the waiver and a reduction in the RVC threshold as means of dealing with the economic and administrative problems of the current CER RoO. They would also be consistent with the trade-liberalising intent of the CER and with initiatives to establish a single trans-Tasman market. The Commission sees the waiver as providing the greatest benefit. It would deliver more broad-based gains and should reduce compliance costs significantly. In response to the interim report, Australian and New Zealand participants favouring liberalisation of the CER RoO widely favoured the Commission's waiver proposal.

RECOMMENDATION 3

***A 'waiver' should be introduced to provide automatic duty free entry to any goods:***

- ***manufactured within Australia or New Zealand (as defined in recommendation 2); and***
- ***for which the difference between the Australian and New Zealand MFN tariff rates is 5 percentage points or less.***

***A waiver, once granted, should not be removed.***

Implementation of recommendations 2 and 3 would leave the current 50 per cent threshold in place for all tariff items for which differences in the MFN tariffs between Australia and New Zealand are at present greater than 5 percentage points. This threshold would remain a significant impediment to the operations of some firms, particularly those that use high value imported inputs.

FINDING

*While priority should be given to the implementation of the waiver (recommendation 3), a reduction in the regional value content threshold would be beneficial, particularly while tariff differences remain greater than 5 percentage points.*

### *Adjustment issues*

Like all policy changes, the proposed waiver (and other liberalising measures) would benefit some, but could also affect particular firms or product lines adversely. The potential difficulties that some producers might face need to be seen in the context of all

likely changes resulting from the liberalisation of CER RoO and the broader gains that would accrue to the community. Overall, the changes should benefit industry by:

- improving access for Australian and New Zealand producers to the markets of the CER partner;
- freeing up purchasing decisions of Australian and New Zealand firms;
- reducing impediments to technical and organisational change; and
- reducing compliance costs.

The proposed changes should thereby improve firms' international competitiveness, allowing them to export more successfully and to compete for market share against imports from third countries. Some Australian and New Zealand firms are likely to increase output and employment.

However, as noted, some firms would face greater competition. At its simplest, this might be the case if any firm that now just fails the CER RoO test and pays the full MFN tariff subsequently obtained duty free entry into the other CER market under the waiver. It would also be the case were firms that now meet the test and receive the tariff concession to increase their use of lower-cost or higher-quality imported content in a bid to gain market share.

In the Commission's view, the scope for adverse impacts on Australian industry from increased New Zealand competition would be small and should not exacerbate the current program of structural adjustment. The waiver would be applied in an environment in which tariff protection afforded to the output of Australian and New Zealand producers is broadly similar in absolute terms and low by historical standards. Moreover, tariffs in both countries are being phased down. In addition, tariff imposts on material inputs are low in Australia and New Zealand, limiting the scope for different tariffs on inputs and duty drawback on imported materials used in the production of goods for export to influence the overall competitiveness of New Zealand producers in the Australian market.

The size of the Australian manufacturing industry relative to the scale of exports of manufactures from New Zealand suggests that even quite large improvements in the competitiveness of New Zealand firms would have only a small overall impact on Australian manufacturers. Imports from New Zealand are equivalent to less than 2 per cent of Australian production of manufactures and represent an even smaller proportion of total sales of such products. Were a waiver to be introduced, perhaps the major additional source of competition from New Zealand initially would be imports that are now subject to duty. Those imports are a tiny share of the Australian production — just 0.05 per cent — suggesting that there is very limited scope for them to impose undue adjustment pressure on Australian industry even over the medium term.

At the sectoral level, imports from New Zealand are greatest for wood and paper products, TCF and other manufacturing**,** where they represent about 6 per cent, 5 per cent and 3 per cent of Australian production, respectively. For the TCF sector, imports from other sources — such as China and European countries — represent more important competition.

Were New Zealand goods to become more competitive in the Australian market as a consequence of the waiver, they could take market share from third country importers as well as Australian firms. For example, both the Australian and New Zealand markets for men's suits and jackets are dominated by supplies from third countries. Imports from New Zealand represent less than 8 per cent of total Australian imports of these garments. (In the case of women's suits, jackets, ensembles and dresses, New Zealand accounts for less than 4 per cent of Australia's imports. In contrast, Australia accounts for 20 per cent of New Zealand's imports of these goods.)

Under plausible assumptions concerning the substitutability of imported and locally produced TCF products, a 5 per cent[4] reduction in the production costs of imports from New Zealand could lead to a reduction in demand for TCF items from other sources, including Australia, of about 0.3 per cent, all other things remaining equal. If, at the extreme, New Zealand supplies substituted only for Australian textiles, clothing and footwear, the demand for Australian-made supplies would be reduced by only about 0.5 per cent (assuming that Australian firms could not match their New Zealand competitors in the local *or* New Zealand markets). Analysis of other potentially affected activities such as chemicals and plastics provided similar results.

The increased opportunities for productivity improvements could offset, at a sectoral level, the effects of additional competition from New Zealand. For example, continuing the above TCF example, a 2 per cent reduction in costs of Australian TCF imported into New Zealand would fully offset the projected decline in Australian TCF output arising from lower-priced New Zealand products.

Similarly, New Zealand industry would face adjustment pressures. Total imports from Australia amount to about 10 per cent of New Zealand production — well above the corresponding ratio of imports from New Zealand to Australian production of 2 per cent. Imports from Australia relative to New Zealand production are greatest for the sectors

4 The postulated 5 per cent reduction in costs is broadly equivalent to a hypothetical removal of all tariffs on textiles used in TCF production where the tariff rate is evaluated at the highest MFN rate. The elasticities of substitution, or Armington elasticities, are based on the upper bound of standard estimates included in the MONASH model of the Australian economy. Input-output relationships used in the analysis are based on Australian and New Zealand data for the years 1996-97 and 1995-96, respectively. The analysis presented is partial and assumes, amongst other things, that there are no supply restrictions.

producing metal products (17 per cent)[5] and petroleum, coal, chemical and associated products (16 per cent). For the TCF sector, imports from Australia amount to 12 per cent of New Zealand production, compared with 5 per cent for imports from New Zealand relative to Australian production. Changes in the competitiveness of Australian firms selling to New Zealand due to the waiver and other factors, therefore, could have a larger impact on New Zealand industry than changes in the competitiveness of New Zealand firms would have on Australian industry.

FINDING

*The impacts of implementing a waiver are expected to be small in aggregate and for particular industries. Consequently, the likelihood of significant adjustment pressures is small.*

While the economy-wide effects of the waiver would be relatively modest, it would encourage Australian and New Zealand firms to reduce costs and increase their productivity. Consumers in Australia and New Zealand would benefit from greater product variety from Australian and New Zealand producers and potentially lower prices.

## Options for longer-term change

Longer-term changes to reduce or eliminate the impact of RoO on economic activity and to further reduce compliance and administration costs would build on the benefits of the above recommendations. Such changes would also contribute to the CER goal of free trade between Australia and New Zealand.

As noted above, as tariffs on both sides of the Tasman continue to fall, RoO (and the duty free entry which they provide) will become less of an issue. This suggests that, in time, the CER content threshold could be removed from the RoO regime altogether and that only the 'principal firm' and manufacturing criteria would need to be maintained. This would, in effect, extend the 'waiver' option to all CER trade. Depending on the realisation of scheduled tariff reductions, this option may be achieved in the normal course of events without explicit policy changes.

Another approach would be to align progressively all remaining non-zero MFN tariff rates in the Australian and New Zealand tariff schedules so that merchandise from all sources

[5] The percentage for motor vehicles and parts, based on the 1995-96 input-output data for New Zealand, is 32 per cent of New Zealand production. However, that understates the current situation because tariffs on passenger and light commercial vehicles (excluding motor homes and ambulances) were reduced subsequently to zero and significant motor vehicle assembly operations ceased by 2000.

would enter each jurisdiction on the basis of a common tariff. This option would have the same tariff effect as establishment of a trans-Tasman customs union and would eliminate altogether the need for preferential RoO between Australia and New Zealand. As tariffs come down in both Australia and New Zealand, the chance that they will settle at the same or similar rates increases. Again, an outcome close to this option is likely with the passage of time.

RECOMMENDATION 4

***Before 2010, consideration should be given to advancing the goals of the CER Agreement by:***

- ***elimination of the CER content threshold, with only a 'principal firm' manufacturing test being applied; and***
- ***alignment of remaining non-zero MFN rates in the Australian and New Zealand tariff schedules, so that ultimately merchandise from all sources enters each jurisdiction on a common basis.***

## Other possible changes

A number of other possible changes were considered to have some merit but were not regarded as practicable for the CER given its advanced stage of development and prevailing, generally low, tariffs. These changes, discussed in chapter 8, include broadening the definition of CER manufacturing costs to include, for example, transport and distribution costs or adopting a method other than factory cost for calculating content.

Viewed in isolation, some of these approaches might have been worth considering if a thorough overhaul of CER RoO was found to be justified. For example, the transaction value build-down method for calculating content was found to have some particular strengths, although little information is available on the likely costs of switching to that method at this stage of the CER's history. (Some participants expressed significant reservations about the application of the method.) The Commission has taken the view that changes of these kinds at this stage are unlikely to be worth the transitional costs they would impose.

Overall, the Commission sees more benefit in attending to day-to-day shortcomings in the RoO and in facilitating a further opening of the trans-Tasman market within the broad framework of the current rules. This would be consistent with the objectives of the CER Agreement, as well as with the principles contained in the *Joint Ministerial Statement on Rules of Origin* of August 2003 and more recent public statements by the Prime Ministers

and Treasury Ministers of both countries concerning the development of a single economic market comprising Australia and New Zealand.

# A Conduct of the study

As part of the study process, the Commission visited or otherwise discussed the issues involved with a number of organisations (section A.1) and, after the release of the interim report, conducted a series of roundtable meetings (section A.2). Forty-seven submissions were received from interested parties (section A.3). The Commission thanks all those who contributed to the study.

## A.1 Visits and discussions

### Australia

- Australian Chamber of Commerce and Industry
- Australian Customs Service
- Council of Textile and Fashion Industries of Australia
- Cue Design Pty Ltd
- Department of Foreign Affairs and Trade
- Department of Industry, Tourism and Resources
- Gummerson Fabrics
- Hot Clothing Company Pty Ltd
- Jackson PMW
- Plastics and Chemicals Industries Association
- Yakka Apparel Solutions Ltd

### New Zealand

- Blackburn Croft & Co
- Business New Zealand
- Cambridge Clothing Co Ltd
- Deane Apparel
- Employers & Manufacturers Association (Northern) Inc
- Fisher & Paykel Appliances Ltd
- Ministry of Economic Development
- Ministry of Foreign Affairs and Trade
- New Zealand Customs Service
- New Zealand Retailers Association
- Norsewear
- New Zealand Footwear Industry Association

- New Zealand Institute of Economic Research
- Rembrandt Suits Ltd
- Textiles New Zealand
- Wellington Regional Chamber of Commerce
- Woolyarns New Zealand

### Other countries

- World Trade Organization (Geneva, Switzerland)
- Organization for Economic Co-operation and Development (Paris, France)

## A.2 Roundtable meetings

### Melbourne, 11 February 2004

Australian Industry Group
Council of Textile and Fashion Industries of Australia
Department of Industry, Tourism and Resources
Dunkley International
Federal Chamber of Automotive Industries
Ford Australia
Harold Boot Company Pty Ltd
Marplex Australia Pty Ltd
Ministry of Economic Development
New Zealand High Commission
Toyota

### Auckland, 17 February 2004

Auckland Chamber of Commerce
Blackburn Croft & Co
Cambridge Clothing Co Ltd
Department of Industry, Tourism and Resources
Employers and Manufacturers Association (Northern)
Hart Manufacturing Ltd
Ministry of Economic Development
Ministry of Foreign Affairs and Trade
New Zealand Customs Service
New Zealand Footwear Industry Association
Textile Bonding Ltd

### Wellington, 18 February 2004

Blackburn Croft & Co
Business New Zealand

Department of Foreign Affairs and Trade
Department of Industry, Tourism and Resources
Ministry of Economic Development
Ministry of Foreign Affairs and Trade
New Zealand Customs Service
New Zealand Retailers Association
New Zealand Institute of Economic Research
Rembrandt Suits Ltd
Textiles New Zealand

### Canberra, 24 February 2004

Australian Customs Service
Australian Chamber of Commerce and Industry
Carpet Institute of Australia Ltd
Council of Textile and Fashion Industries of Australia
Department of Foreign Affairs and Trade
Department of Industry, Tourism and Resources
Kershaw, Mr Jeff
Ministry of Economic Development
New Zealand High Commission
Plastics and Chemicals Industries Association
Treasury

## A.3 Submissions received

| Organisation | Submission no. |
|---|---|
| Australian Customs Service | 24, 32 |
| Australian Industry Group | 4, 29 |
| Australian Made Campaign Limited | 5 |
| Australia–New Zealand Business Council Inc | 40 |
| Business New Zealand | 7, 30 |
| Cambridge Clothing Co Ltd | 19, 35, 43 |
| Canterbury Manufacturers' Association | 44 |
| Carpet Institute of Australia Ltd | 14, 42 |
| Coles Myer Ltd | 9, 31 |
| Council of Textile and Fashion Industries of Australia | 12, 34 |
| Country Road Clothing Pty Ltd | 22 |
| Cue Design Pty Ltd | 6 |
| Cutbush, Mr Greg | 45 |
| Department of Foreign Affairs and Trade | 10, 37 |
| Department of Industry, Tourism and Resources | 16, 28 |

# B Stocktake of preferential trade agreements

This appendix (table B.1) lists the PTAs notified to the GATT/WTO (as having entered into force) since 1947 (WTO 2003e). For each agreement the table shows the member countries and date of entry into force.

The WTOs listing shows PTAs each time they are 'notified' to the WTO. Several agreements have been notified on more than one occasion. For example, agreements that cover trade in merchandise and services are included twice by the WTO as they are notified under two different clauses (GATT Article XXIV and GATS Article V). In addition, PTAs that have changed membership (for example when new countries entered the agreement) are notified once when the agreement entered into force and again when new members joined the agreement.

In table B.1 agreements have been included when they first entered into force and when their membership has changed. Agreements that cover both merchandise and services have only been included once.

Table B.1 **Preferential trade agreements**
Number and date of entry into force

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| European Community (Now European Union) (1958) | 1-Jan-58 | Belgium, France, Germany, Italy, Luxembourg, Netherlands |
| EFTA (European Free Trade Association) (1960) | 3-May-60 | Austria, Denmark, Liechtenstein, Norway, Portugal, Sweden, Switzerland, United Kingdom |
| EFTA (1961) | 1-Jan-61 | EFTA (1960), Finland |
| CACM (Central American Common Market) | 12-Oct-61 | Guatemala, El Salvador, Honduras, Nicaragua |
| The Tripartite Agreement | 1-Apr-68 | Egypt, India, Yugoslavia |
| EFTA (1970) | 1-Jan-70 | EFTA (1961), Iceland |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| EC–OCTs (overseas countries and territories) | 1-Jan-71 | European Community,[a] Anguilla, Aruba, Ascension Island, British Antarctic Territory, British Indian Ocean Territory, British Virgin Islands, Cayman Islands, Falkland Islands, French Polynesia, French Southern and Antarctic Territories, Mayotte, Montserrat, Netherlands Antilles (Bonaire, Curaçao, Saba, St. Eustatius, St. Maarten), New Caledonia, Pitcairn, St. Helena, St. Pierre and Miquelon, South Georgia and South Sandwich Islands, Tristan da Cunha, Turks and Caicos Islands, Wallis and Futuna Islands, Greenland |
| EC–Malta | 1-Apr-71 | European Community,[a] Malta |
| EFTA (1973) | 1-Jan-73 | EFTA(1970) *excluding* Denmark, United Kingdom |
| EC (1973) | 1-Jan-73 | EC (1958), Denmark, Ireland, United Kingdom |
| EC–Switzerland and Liechtenstein | 1-Jan-73 | European Community,[a] Liechtenstein, Switzerland |
| Protocol Relating to Trade Negotiations Among Developing Countries | 11-Feb-73 | |
| EC–Iceland | 1-Apr-73 | European Community,[a] Iceland |
| EC–Cyprus | 1-Jun-73 | European Community,[a] Cyprus |
| EC–Norway | 1-Jul-73 | European Community,[a] Norway |
| CARICOM (Caribbean Community and Common Market, now Caribbean Community) | 1-Aug-73 | Antigua and Barbuda, The Bahamas (The Bahamas is a member of the Community but not the Common Market), Barbados, Belize, Dominica, Grenada, Guyana, Haiti, Jamaica, Montserrat, St. Kitts and Nevis, St. Lucia, St. Vincent and the Grenadines, Suriname, Trinidad and Tobago |
| Bangkok Agreement | 17-Jun-76 | Bangladesh, India, Laos, the Philippines, the Republic of Korea, Sri Lanka, Thailand |
| EC–Algeria | 1-Jul-76 | European Community,[a] Algeria |
| PATCRA | 1-Feb-77 | Australia, Papua New Guinea |
| EC–Egypt | 1-Jul-77 | European Community,[a] Egypt |
| EC–Lebanon | 1-Jul-77 | European Community,[a] Lebanon |
| EC–Syria | 1-Jul-77 | European Community,[a] Syria |
| EC (1981) | 1-Jan-81 | EC(1973), Greece |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| SPARTECA (South Pacific Trade and Regional Cooperation Agreement) | 1-Jan-81 | Australia, Cook Islands, Fiji, Kiribati, Nauru, New Zealand, Niue, Papua New Guinea, Solomon Islands, Tonga, Tuvalu, Western Samoa |
| LAIA (Latin American Integration Association) | 18-Mar-81 | Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay and Venezuela |
| CER (Australia–New Zealand Closer Economic Relations Trade Agreement) | 1-Jan-83 | Australia, New Zealand |
| ECO (Economic Cooperation Organization) | 11-Oct-84[b] | Afghanistan, Azerbaijan, Iran, Kazakhstan, Kyrgyz Republic, Pakistan, Tajikistan, Turkey, Turkmenistan, Uzbekistan |
| United States–Israel | 19-Aug-85 | Israel, United States |
| EFTA (1986) | 1-Jan-86 | EFTA(1973) *excluding* Portugal |
| EU (1986) | 1-Jan-86 | EC(1981), Portugal, Spain |
| ANDEAN (Andean Subregional Integration Agreement —Cartagena Agreement) | 25-May-88 | Bolivia, Colombia, Ecuador, Peru, and Venezuela, |
| GSTP (The Global System Of Trade Preferences Among Developing Countries) | 19-Apr-89 | Algeria, Argentina, Bangladesh, Benin, Bolivia, Brazil, Cameroon, Chile, Colombia, Cuba, Democratic People's Republic of Korea, Ecuador, Egypt, Ghana, Guinea, Guyana, India, Indonesia, Iran, Iraq, Libya, Malaysia, Mexico, Morocco, Mozambique, Myanmar, Nicaragua, Nigeria, Pakistan, Peru, Philippines, Republic of Korea, Romania, Singapore, Sri Lanka, Sudan, Thailand, Trinidad and Tobago, Tunisia, Tanzania, Venezuela, Vietnam, Yugoslavia, Zimbabwe |
| Laos–Thailand | 20-Jun-91 | Laos, Thailand |
| EC–Andorra | 1-Jul-91 | European Community,[a] Andorra |
| MERCOSUR (Southern Common Market) | 29-Nov-91 | Argentina, Brazil, Paraguay, Uruguay |
| ASEAN (Association of South East Asian Nations) Free Trade Area | 28-Jan-92 | Brunei, Indonesia, Malaysia, Philippines, Singapore, Thailand |
| EU–Hungary | 1-Mar-92 | European Union,[a] Hungary |
| EU–Poland | 1-Mar-92 | European Union,[a] Poland |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| EU–Czech Republic | 1-Mar-92 | European Union,[a] Czech Republic |
| EU–Slovak Republic | 1-Mar-92 | European Union,[a] Slovak Republic |
| EFTA–Turkey | 1-Apr-92 | EFTA Countries,[c] Turkey |
| EFTA–Czech Republic | 1-Jul-92 | EFTA countries,[c] Czech Republic |
| EFTA–Slovak Republic | 1-Jul-92 | EFTA countries,[c] Slovak Republic |
| GCC (Gulf Cooperation Council) | 22-Jul-92[b] | Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, United Arab Emirates |
| EFTA–Israel | 1-Jan-93 | EFTA countries,[c] Israel |
| Czech Republic–Slovak Republic | 1-Jan-93 | Czech Republic, Slovak Republic |
| CEFTA (Central European Free Trade Agreement) (1993) | 1-Mar-93 | Czech Republic, Hungary, Poland, Slovak Republic |
| Kyrgyz Republic–Russian Federation | 24-Apr-93 | Kyrgyz Republic, Russian Federation |
| EFTA–Romania | 1-May-93 | EFTA countries,[c] Romania |
| EU–Romania | 1-May-93 | European Union,[a] Romania |
| EFTA–Bulgaria | 1-Jul-93 | EFTA countries,[c] Bulgaria |
| Faroe Islands–Iceland | 1-Jul-93 | Faroe Islands, Iceland |
| Faroe Islands–Norway | 1-Jul-93 | Faroe Islands, Norway |
| MSG (Melanesian Spearhead Group) | 22-Jul-93 | Fiji, Papua New Guinea, Solomon Islands, Vanuatu |
| EFTA–Hungary | 1-Oct-93 | EFTA countries,[c] Hungary |
| EFTA–Poland | 15-Nov-93 | EFTA countries,[c] Poland |
| EU–Bulgaria | 31-Dec-93 | European Union,[a] Bulgaria |
| NAFTA (North American Free Trade Agreement) | 1-Jan-94 | Canada, Mexico, United States |
| EEA (European Economic Area) | 1-Jan-94 | European Union,[a] EFTA countries[c] |
| BAFTA (Baltic Free Trade Agreement) | 1-Apr-94 | Latvia, Estonia and Lithuania |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| Georgia–Russian Federation | 10-May-94 | Georgia, Russian Federation |
| COMESA (Common Market For Eastern And Southern Africa) | 8-Dec-94 | Angola, Burundi, Comoros, Democratic Republic of Congo, Djibouti, Egypt, Eritrea, Ethiopia, Kenya, Madagascar, Malawi, Mauritius, Namibia, Rwanda, Seychelles, Sudan, Swaziland, Uganda, Zambia, Zimbabwe |
| CIS (Commonwealth of Independent States) | 30-Dec-94 | Azerbaijan, Armenia, Belarus, Georgia, Moldova, Kazakhstan, The Russian Federation, Ukraine, Uzbekistan, Tajikistan, Kyrgyz Republic |
| EFTA (1995) | 1-Jan-95 | EFTA(1986) *excluding* Austria, Sweden, Finland |
| EU (1995) | 1-Jan-95 | EU(1986), Austria, Sweden, Finland |
| EU–Estonia | 1-Jan-95 | European Union,[a] Estonia |
| EU–Latvia | 1-Jan-95 | European Union,[a] Latvia |
| EU–Lithuania | 1-Jan-95 | European Union,[a] Lithuania |
| Romania–Moldova | 1-Jan-95 | Romania, Moldova |
| EU–Bulgaria | 1-Feb-95 | European Union,[a] Bulgaria |
| Faroe Islands–Switzerland | 1-Mar-95 | Faroe Islands, Switzerland |
| EFTA–Slovenia | 1-Jul-95 | EFTA countries,[c] Slovenia |
| Kyrgyz Republic–Armenia | 27-Oct-95 | Armenia, Kyrgyz Republic |
| Kyrgyz Republic–Kazakhstan | 11-Nov-95 | Kazakhstan, Kyrgyz Republic |
| SAPTA (SAARC–South Asian Association for Regional Cooperation–Preferential Trading Arrangement) | 7-Dec-95 | Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan, Sri Lanka |
| CEFTA (1996) | 1-Jan-96 | CEFTA(1993), Slovenia |
| EU–Turkey | 1-Jan-96 | European Union,[a] Turkey |
| Estonia–Ukraine | 14-Mar-96 | Estonia, Ukraine |
| EFTA–Estonia | 1-Jun-96 | EFTA countries,[c] Estonia |
| EFTA–Latvia | 1-Jun-96 | EFTA countries,[c] Latvia |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| Georgia–Ukraine | 4-Jun-96 | Georgia, Ukraine |
| Georgia–Azerbaijan | 10-Jul-96 | Azerbaijan, Georgia |
| EFTA–Lithuania | 1-Aug-96 | EFTA countries,[c] Lithuania |
| Slovenia–Latvia | 1-Aug-96 | Latvia, Slovenia |
| Slovenia–Former Yugoslav Republic of Macedonia | 1-Sep-96 | Former Yugoslav Republic of Macedonia, Slovenia |
| Kyrgyz Republic–Moldova | 21-Nov-96 | Kyrgyz Republic, Moldova |
| EU–Slovenia | 1-Jan-97 | European Union,[a] Slovenia |
| Canada–Israel | 1-Jan-97 | Canada, Israel |
| EU–Faroe Islands | 1-Jan-97 | European Union,[a] Faroe Islands |
| Slovenia–Estonia | 1-Jan-97 | Estonia, Slovenia |
| Poland–Lithuania | 1-Jan-97 | Lithuania, Poland |
| Slovak Republic–Israel | 1-Jan-97 | Israel, Slovak Republic |
| Slovenia–Lithuania | 1-Mar-97 | Lithuania, Slovenia |
| Israel–Turkey | 1-May-97 | Israel, Turkey |
| CEFTA (1997) | 1-Jul-97 | CEFTA(1996), Romania |
| EU–Palestinian Authority | 1-Jul-97 | European Union,[a] Palestinian Authority |
| Czech Republic–Latvia | 1-Jul-97 | Czech Republic, Latvia |
| Slovak Republic–Latvia | 1-Jul-97 | Latvia, Slovak Republic |
| Slovak Republic–Lithuania | 1-Jul-97 | Lithuania, Slovak Republic |
| Canada–Chile | 5-Jul-97 | Canada, Chile |
| Czech Republic–Lithuania | 1-Sep-97 | Czech Republic, Lithuania |
| EAEC (Eurasian Economic Community) | 8-Oct-97 | Kyrgyz Republic, Russian Federation, Belarus, Kazakhstan, Tajikistan |
| Czech Republic–Israel | 1-Dec-97 | Czech Republic, Israel |
| Slovenia–Croatia | 1-Jan-98 | Croatia, Slovenia |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| Kyrgyz Republic–Ukraine | 19-Jan-98 | Kyrgyz Republic, Ukraine |
| Hungary–Israel | 1-Feb-98 | Hungary, Israel |
| Romania–Turkey | 1-Feb-98 | Romania, Turkey |
| Czech Republic–Estonia | 12-Feb-98 | Czech Republic, Estonia |
| Slovak Republic–Estonia | 12-Feb-98 | Estonia, Slovak Republic |
| Lithuania–Turkey | 1-Mar-98 | Lithuania, Turkey |
| Poland–Israel | 1-Mar-98 | Israel, Poland |
| EU–Tunisia | 1-Mar-98 | European Union,[a] Tunisia |
| Kyrgyz Republic–Uzbekistan | 20-Mar-98 | Kyrgyz Republic, Uzbekistan |
| Hungary–Turkey | 1-Apr-98 | Hungary, Turkey |
| Estonia–Turkey | 1-Jun-98 | Estonia, Turkey |
| Slovenia–Israel | 1-Sep-98 | Israel, Slovenia |
| Slovak Republic–Turkey | 1-Sep-98 | Slovak Republic, Turkey |
| Czech Republic–Turkey | 1-Sep-98 | Czech Republic, Turkey |
| Georgia–Armenia | 11-Nov-98 | Armenia, Georgia |
| Estonia–Faroe Islands | 1-Dec-98 | Estonia, Faroe Islands |
| CEFTA (1999) | 1-Jan-99 | CEFTA(1997), Bulgaria |
| Bulgaria–Turkey | 1-Jan-99 | Bulgaria, Turkey |
| Poland–Faroe Islands | 1-Jun-99 | Faroe Islands, Poland |
| Poland–Latvia | 1-Jun-99 | Latvia, Poland |
| CEMAC (Economic And Monetary Community Of Central Africa) | 24-Jun-99 | Cameroon, Central African Republic, Chad, Congo, Gabon, Equatorial Guinea |
| EFTA–Palestinian Authority | 1-Jul-99 | EFTA countries,[c] Palestinian Authority |
| Georgia–Kazakhstan | 16-Jul-99 | Georgia, Kazakhstan |
| Chile–Mexico | 1-Aug-99 | Chile, Mexico |
| EFTA–Morocco | 1-Dec-99 | EFTA countries,[c] Morocco |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| Hungary–Latvia | 1-Jan-00 | Hungary, Latvia |
| Bulgaria–Former Yugoslav Republic of Macedonia | 1-Jan-00 | Bulgaria, Former Yugoslav Republic of Macedonia |
| WAEMU (West African Economic and Monetary Union) | 1-Jan-00 | Benin, Burkina Faso, Côte d'Ivoire, Mali, Niger, Senegal, Togo |
| EU–South Africa | 1-Jan-00 | European Union,[a] South Africa |
| Georgia–Turkmenistan | 1-Jan-00 | Georgia, Turkmenistan |
| Hungary–Lithuania | 1-Mar-00 | Hungary, Lithuania |
| Poland–Turkey | 1-May-00 | Poland, Turkey |
| EU–Israel | 1-Jun-00 | European Union,[a] Israel |
| Turkey–Slovenia | 1-Jun-00 | Slovenia, Turkey |
| EU–Mexico | 1-Jul-00 | European Union,[a] Mexico |
| Latvia–Turkey | 1-Jul-00 | Latvia, Turkey |
| Mexico–Israel | 1-Jul-00 | Israel, Mexico |
| EAC (East African Community) | 7-Jul-00 | Kenya, Tanzania, Uganda |
| Turkey–Former Yugoslav Republic of Macedonia | 1-Sep-00 | Former Yugoslav Republic of Macedonia, Turkey |
| EFTA–Former Yugoslav Republic of Macedonia | 1-Jan-01 | EFTA countries,[c] Former Yugoslav Republic of Macedonia |
| New Zealand–Singapore | 1-Jan-01 | New Zealand, Singapore |
| Hungary–Estonia | 1-Mar-01 | Estonia, Hungary |
| EU–FYROM | 1-Jun-01 | European Union,[a] Former Yugoslav Republic of Macedonia |
| EFTA–Mexico | 1-Jul-01 | EFTA countries,[c] Mexico |
| India–Sri Lanka | 15-Dec-01 | India, Sri Lanka |
| United States–Jordan | 17-Dec-01 | Jordan, United States |
| Slovenia–Bosnia and Herzegovina | 1-Jan-02 | Bosnia and Herzegovina, Slovenia |

(Continued next page)

Table B.1 **(continued)**

| *Agreement* | *Date of entry into force* | *(Current) Members* |
|---|---|---|
| EFTA–Jordan | 1-Jan-02 | EFTA countries,[c] Jordan |
| EFTA–Croatia | 1-Jan-02 | EFTA countries,[c] Croatia |
| Bulgaria–Estonia | 1-Jan-02 | Bulgaria, Estonia |
| Bulgaria–Israel | 1-Jan-02 | Bulgaria, Israel |
| Chile–Costa Rica | 15-Feb-02 | Chile, Costa Rica |
| EU–Croatia | 1-Mar-02 | European Union,[a] Croatia |
| Bulgaria–Lithuania | 1-Mar-02 | Bulgaria, Lithuania |
| EU–Jordan | 1-May-02 | European Union , Jordan |
| Canada–Costa Rica | 1-Nov-02 | Canada, Costa Rica |
| Japan–Singapore | 30-Nov-02 | Japan, Singapore |
| EFTA–Singapore | 1-Jan-03 | EFTA countries,[c] Singapore |
| Bulgaria–Latvia | 1-Apr-03 | Bulgaria, Latvia |
| Turkey–Bosnia and Herzegovina | 1-Jul-03 | Bosnia and Herzegovina, Turkey |
| Turkey–Croatia | 1-Jul-03 | Croatia, Turkey |
| Singapore–Australia | 28-Jul-03 | Australia, Singapore |
| EU (2004) | 1-May-04 | EU(1995), Czech Republic, Estonia, Cyprus, Latvia, Lithuania, Hungary, Malta, Poland, Slovenia, and Slovakia |

**a** Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, Netherlands, Portugal, Spain, Sweden, United Kingdom **b** Date of WTO notification (date of entry into force is unavailable) **c** Iceland, Liechtenstein, Norway, Switzerland.

*Source*: WTO (2003e).

# C Definitions of manufacture under the CER

The current CER RoO require that the last place of manufacture occurs within Australia or New Zealand. In view of the importance of this test to the current RoO, and for possible future tests for granting origin, this appendix outlines the Customs guidance and case law available for determining whether or not a manufacturing process has occurred.

The concept of manufacture under the CER is subject to the normal rules of legislative interpretation by tribunals and courts. While Customs guidance is useful in indicating how the agencies will apply the law, it is the legal interpretation of the term which provides its actual meaning. Hence, an understanding of the case law is needed to ensure the correct use of the term and to evaluate Customs guidance.

This appendix first outlines the guidance provided by both the Australian and New Zealand Customs Services on how to determine whether a good is manufactured. The authority (case law) for such guidance is then examined. This appendix then looks at the features of the current manufacture test. Finally, the relationship between, and compatibility of, the current test with other agreements and frameworks is examined.

## Australian and New Zealand Customs' guidance

The term 'manufacture' is not defined under the CER agreement or s. 153B of the *Customs Act 1901*. However, both Customs Services provide guidance on the interpretation of the term. Australian Customs (ACS) provides guidance on its interpretation of manufacture in Volume 8 of the *ACS Manual* (Australian Customs 2003a) and both Customs Services use a joint publication *ANZCERTA – Rules of Origin – Rules Governing Entitlement to Preferential Rates of Duty for Trans-Tasman Trade* (New Zealand Customs 2003b). Details of the guidance are provided in box C.1.

According to the ACS, determinations of manufacture depend upon producing a good which is 'essentially different' from the materials used in its production. Minor operations and restoration processes are explicitly ruled out as processes of manufacture. Under the joint guidance, the final good has to be 'essentially different in character, identity, form, function, description and commercial understanding' from its inputs. Further, it notes that manufacture 'must involve a significant change in the form or function' of the inputs.

Box C.1 **Customs' guidance**

**Australian Customs Manual**

(2) … Manufacture requires the creation of an article *essentially different* from the component parts or materials that go into such manufacture.

(3) What is 'manufacture' in any particular case must be determined on a case-by-case basis with due regard being paid to the nature of the goods concerned and the processes to which they have been subjected.

(4) Processes such as repairing, overhauling or re-furbishing do not constitute manufacture as they are restoration processes …

(5) In keeping with the above, minor processing operations such as pressing, labelling, ticketing, packaging, preparation for sale and quality control inspections will not be considered to be processes of manufacture in their own right.

(6) Generally, however, minor processing operations will be treated as part of overall manufacture, provided there is a single continuous line of production at the factory from primary materials to finished goods ready for sale.

**Joint New Zealand/Australia Customs Publication: ANZCERTA – Rules of Origin.**

Manufacture involves making one thing out of another, the new being essentially different in character, identity, form, function, description and commercial understanding from the other.

Manufacture must involve a significant change in the form or function of the thing said to be manufactured, compared with its unmanufactured or previously manufactured state.

On the other hand, repairing, re-conditioning, overhauling or re-furbishing do not constitute manufacture as these are restoration processes.

Certain minimal operations or processes will generally not, by themselves, be considered to constitute manufacture. Although not exhaustive, examples of such minimal operations or processes include:

- affixing of marks, labels or distinguishing signs on goods or their packages
- application of grease, anti-rust paint or protective coating
- chilling
- cleaning or washing
- crushing
- dilution with water or any other aqueous solution
- grouping of packages
- husking, shelling or stoning
- ionizing

(Continued next page)

Box C.1 (continued)

- packing, unpacking, repacking or breaking bulk
- removing of damaged parts
- salting testing or calibration
- sifting, screening or sorting
- spreading out
- ventilation or drying

In certain situations, whether or not manufacture has occurred in Australia or New Zealand can only be established on a case-by-case basis with due regard to the facts, e.g., the nature of the imported component parts or materials at the beginning of the process, the process or processes performed in Australia or New Zealand, and the nature of the goods the result of the process or processes, noting that there must be the creation of a new good and different article.

*Sources:* Australian Customs (2003c, s. 9.8.2) and New Zealand Customs (2003b).

The codification of the general definition in the Customs guidance takes the form of a 'negative' test. Under this test, activities deemed by Customs not to constitute manufacture, such as restoration and minor processing operations, are specified. The advantage of a negative test is that it does not codify what does constitute manufacturing, which provides commercial flexibility while meeting conceptual requirements. The disadvantage of the approach is that it might lead to the exclusion of a process which would be properly considered to constitute manufacture under the overarching concept.

## Definition of manufacture under CER

The definition of manufacture under the CER agreement has been addressed specifically only in the *Jolly O* case.[1] This case provides guidance on the criteria that might be used to define manufacturing under the CER agreement.

Deputy President McDonald stated that the CER 'does not define the term "manufacture" …' and as a result, the meaning 'should be determined by reference to the meaning ordinarily attributed'. To assist in determining the ordinary meaning of manufacture, the Deputy President utilised cases where the 'legislative provisions define manufacture but in a way not inconsistent with the generally accepted dictionary and common law meanings'.[2]

1 *Re Regal Holdings Ltd and CEO of Customs* (1997) 46 ALD 373, a decision by the AAT. Another AAT case, Re *Gaylor Jewellary Pty Ltd and Collector of Customs* (1990) 12 AAR 86, while dealing with the CER RoO, centred around the definition of 'allowable materials' rather than 'manufacture'.

2 Ibid., at p. 376.

The ordinary meaning of manufacturing has been interpreted by the High and Federal Courts. As mentioned, these interpretations, rather than Customs guidance, provide the ultimate legal meaning of manufacture under CER.

### *Ordinary meaning of 'manufacture'*

The majority of cases dealing with the ordinary meaning of manufacture involve disputes over sales tax liability — under the former Sales Tax Act, sales tax was applicable to manufactured goods. The High Court has consistently stated that there is nothing in the Act to prevent applying the word as it is 'ordinarily applied in English speech'.[3] Therefore, the definitions and cases below can be used as guidance for the definition of manufacture under the CER.

A widely cited definition of manufacture was provided in the British case *McNicol v Pinch* [1906] 2 KB 352 at p. 361, as per Darling J (*McNicol*):

> The essence of making or of manufacturing is that what is made shall be a different thing from that out of which it is made.

The Australian High Court stated in 1935:

> … the primary meaning of the word manufacture is something made by hand as distinguished from a natural growth. But machinery has largely supplanted the manual method, and a manufacture is thus any article or material produced by the application of physical labour or mechanical power.[4]

In *Commonwealth v Genex* (1992) 110 ALR 154 at p. 159 (*Genex*), the High Court acknowledged:

> It has long been accepted that one is required to ask whether that which is made is a "different thing" from that out of which it is made. And, equally, it is no novel proposition to say that this question is on occasion difficult to answer.

An instructive case is the Federal Court decision in *Commissioner of Taxation v Softex Industries* (2001) 191 ALR 724. In this case, Justices Ryan, Dowsett and Hely[5] in an analysis of the legal conception of manufacture, cited *McNicol* and *Genex* to confirm that the legal conception is based on the making of a 'different thing from that out of which it is made'. Their Honours said:

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3 *FCT v Rochester* (1934) 50 CLR 225, per Dixon J at p. 227. Also *Irving v Munro & Sons Ltd* (1931) 46 CLR 279; *Adams v Rau* (1931) 46 CLR, at pp. 577-8; *FCT v Jax Tyres Pty Ltd* (1984) 58 ALR 138, at p. 140.

4 *FCT v Riley* (1935) 53 CLR 69, per Starke J.

5 *Softex*, at pp. 726-729.

- In determining whether a thing is different from the things from which it is made reference should be made not only to the difference in the physical characteristics 'but also the difference in its utility for some purposes.' (*M P Metals*)[6]
- Alteration of an existing thing without production of a new item is not manufacture. (*Jack Zinader*)[7]

Further, they quoted from *M P Metals*, as per Windeyer J:

> Identity and difference, as concepts, must always be related to some quality of the thing or things in respect of which identity or difference is to be determined. It may be colour, shape, chemical composition or any other quality. To speak of "substantial differences", as distinct from small differences, means little or nothing, unless some quality of the thing is postulated as its essential. And whether a thing is so different a thing from the thing or things out of which it was made as to be properly described as a new commodity may depend not only upon physical characteristics but also on differences in its utility for some purpose.[8]
>
> These operations did not create a thing having a new industrial use; and according to what seem to me the ordinary usages of the language of commerce, the processed scrap is not manufactured goods.[9]

The Federal Court concluded that the scope and nature of the legal conception is not in dispute[10] and this conclusion is consistent with the High Court's observation in *Genex.*

While the ultimate decision on whether a process is manufacture can only be decided with reference to the facts of the case (*FCT v Jax Tyres* (1984) 58 ALR 138), previous cases do provide some guidance on types of processes that do *not* constitute manufacturing.

### *Assembly processes*

Mere assembly of goods to produce a finished good is not a process of manufacture. In *Irving v Munro & Sons Ltd* (1931) 46 CLR 279 the distributing agent imported disassembled 'motor-cycles' from England in individual cases which contained all the materials needed to assemble — by a worker with the aid of a spanner only — a motor-cycle but for tyres and tubes. The High Court held that there was no activity which amounted to 'manufacture'. In *Re Tubemakers of Australia Pty Ltd and Collector of Customs* (1980) 3 ALD 199 at p. 210, the Full Tribunal of the AAT stated that assembly occurs when there is 'sufficient of the components or parts to produce, if notionally

6 *M P Metals Pty Ltd v FCT* (1968) 117 CLR 631 at p. 638.

7 *FCT v Jack Zinader Pty Ltd* (1949) 78 CLR 336 at p. 345.

8 *M P Metals*, at p. 638.

9 Ibid., at p. 641.

10 *Softex*, at p. 728.

assembled, goods which though incomplete or unfinished nevertheless have the essential character' of the finished good.

### *'Saleable' processes*

Processes which make the good easier to sell, or more saleable, are not regarded as processes of manufacture. Adapting materials for sale, which do not produce a 'commercially distinct article', are saleable processes. *Softex* held that bales of waste paper were not commercially distinct from the waste paper out of which they had been made. Similarly, the High Court held in *M P Metals* that collecting scrap metal and cutting and pressing it into baled scrap was not a process of manufacturing; it merely made the scrap metal more saleable.

Annex C.1 lists some processes that courts and tribunals have assessed using the common law definition of manufacturing. The annex also outlines whether these processes were regarded as manufacturing processes. However, it is inadvisable to state categorically that certain processes are or are not manufacturing — as noted in *Softex* at p. 727, the large number of cases dealing with particular processes 'are largely without precedential value, as they all depend upon their own facts.'

Box C.2 contains a definition of manufacture based upon the legal cases identified above. While it is possible to use slightly different wording, the definition provided attempts to replicate the courts' terminology as much as possible.

## Reconciliation of case law based definition and Customs guidance

Well-established legal precedence would appear to provide an operational definition of manufacture. The two tests suggested in the cases examined — change in physical characteristics and differences in utility for some purpose — are used to determine whether a new good is manufactured or not. They are therefore able to provide specific guidance to all parties and the meaning of the terms seems easy to understand. Also, the legal conception of manufacture (as noted in *Genex* and *Softex*) is 'not in dispute' and 'has long been accepted'.

Box C.2 **A definition of manufacture based on case law**

Using the terminology of Australian courts, manufacture can be defined as:

> A process that results in a good that is commercially distinct — in physical characteristics and in its utility for some purposes — from the thing or things which went into its production.

The term 'commercially distinct' was used in *Softex* to reflect the concept of difference in characteristics and utility from one good to another. It distinguishes between manufactured good and other goods which may be distinct only in physical characteristics, including goods subject to minor processing, including distribution services, and is used here in the same sense.

Applying a negative test to codify what constitutes manufacture according to this definition, the above discussion suggests that processes that would not be regarded as manufacture include:

- assembly of parts;
- adding components or parts to an otherwise unfinished good;
- alteration of existing goods, which does not alter the nature of the good; and
- processes which make goods more saleable or attractive to potential customers.

*Sources: Commissioner of Taxation v Softex Industries* (2001) 191 ALR 724 (Federal Court); *M P Metals Pty Ltd v FCT* (1968) 117 CLR 631 (High Court); *Irving v Munro & Sons Ltd* (1931) 46 CLR 279 (High Court); *Re Tubemakers of Australia Pty Ltd and Collector of Customs* (1980) 3 ALD 199 (AAT); *FCT v Jack Zinader Pty Ltd* (1949) 78 CLR 336 (High Court).

The Customs guidance material appears broadly similar to and consistent with the legal conception of manufacture (box C.2) — both involve processes of significant transformation of material inputs using labour and capital. However, there appear to be some wording differences between the two frameworks. For example, the legal cases have evolved to refer to the need for a good to be 'commercially distinct', whereas Customs guidance refers to changes in the 'essential nature' of the good and that there be 'significant change' in form or function.

The courts have not focused specifically on determining whether a good is essentially different from it inputs when determining whether the transformation from materials to the final good constitutes manufacture. However, Justice Windeyer in *M P Metals* (1968) 117 CLR 631 at p. 638 did refer briefly to essential difference:

> To speak of "substantial differences", as distinct from small differences, means little or nothing, unless some quality of the thing is postulated as its essential.

Rather than focusing on this, Windeyer J continued to emphasise that a manufactured good must be different 'in its utility for some purpose'[11] from the inputs from which it was made. Again, while the Customs guidance (box C.1) uses different wording — referring to the 'nature of the goods concerned' and a 'change in the function' of the inputs — it does not seem likely that the different wording would unduly affect determinations of manufacturing processes.

However, while ordinarily there would appear to be little meaningful difference between the two modes of expression, it is always possible that under some circumstance such differences might contribute to uncertainty concerning what constitutes manufacture and of Customs determinations that may require legal clarification.

Definitions in the Customs guidance and legal frameworks do not treat minor processes, assembly processes, repair and maintenance or processes which make goods more saleable as manufacturing processes. Accordingly, reliance on the current manufacturing definition, supported by legal precedence and the associated negative list, should preclude preferential status under CER being afforded to goods originating in third countries and shipped through one CER partner to the other. That is, the current definition should preclude the 'transhipment' of goods not originating in CER between CER partners.

## Relationship with other agreements and frameworks

### *Singapore–Australia Free Trade Agreement*

Unlike the CER agreement, the SAFTA contains a legislative definition of what constitutes manufacture — s. 153UA of the *Customs Act 1901* (box C.3). Some submissions have advocated the adoption of the SAFTA definition — for example, Australian Customs (sub. 32, p. 2), TFIA (sub. 34, p. 5) and Fisher & Paykel (sub. 36, p. 2).

The SAFTA definition is closely aligned to the Customs guidance on what constitutes manufacture under the CER. In particular, the SAFTA definition focuses on the creation of a good that is 'essentially different' from the inputs from which it is made, as does the Customs guidance (box C.1). Both frameworks also adopt a negative test to codify the boundary of what constitutes manufacture. Subject to the foregoing discussion on differences in wording in the Customs guidance and legal frameworks, the SAFTA definition also appears to be consistent with the case law based definition as outlined in box C.2.

11 *M P Metals*, at p. 638.

Box C.3 **SAFTA definition of manufacture**

Manufacture means the creation of an article essentially different from the matters or substances that go into such manufacture and does not include the following activities (whether performed alone or in combination with each other):

(a) restoration or renovation processes such as repairing, reconditioning, overhauling or refurbishing;

(b) minimal operations;

(c) quality control inspections.

*Source:* s. 153UA *Customs Act 1901* (Cwth).

### *Australia and New Zealand Standard Industrial Classification*

The Commission's interim report proposed the manufacturing definition should be based on the ANZSIC. Several submissions have questioned the ability of the ANZSIC to provide a robust definition of manufacture — for example, DITR (sub. 28, p. 4), Australian Industry Group (sub. 29, p. 3), Australian Customs (sub. 32, p. 2), EMA New Zealand (sub. 33, p. 3), TFIA (sub. 34, p. 4) and Fisher & Paykel (sub. 36, p. 2). This section examines whether manufacturing determinations under the ANZSIC would result in any material change compared with the current test.

Manufacturing activities are classified to the ANZSIC manufacturing division according to the following definition:

> In a broad sense manufacturing relates to the physical or chemical transformation of materials or components into new products, whether the work is performed by power driven machines or by hand. (ABS 1993, p. 47)

The ANZSIC codifies activities that the official statistical agencies in Australia and New Zealand have determined to be characteristic of — or primary to — industries defined in the classification — including manufacturing — on the basis of international standards for industry classification and research into the organisation of industry in Australia and New Zealand.

Again, although there are wording differences, the definition of what constitutes manufacturing adopted in the ANZSIC conforms with the definition in Customs guidance and legal determinations. This is illustrated by the AAT in *Re Kimberley-Clark Australia and Secretary, DITR* (2003) 75 ALD 287.

This case involved a dispute over the classification of a product within the ANZSIC. The Tribunal agreed that a good's classification should depend upon the overall manufacturing activity undertaken, rather than its composite parts:

> In each case, it is the overall manufacturing activity – the sum of it composite parts, which is the activity on which the focus should be placed when classifying activities for the purpose of the scheme. (p. 302)

The Tribunal also noted that the primary activities listed under each class are not exhaustive and should not be interpreted narrowly:

> In the Tribunal's opinion, the scheme only makes sense if the focus is on the overall manufacturing activity rather than its composite parts.
>
> … the list of primary activities … is non-exhaustive and, presumably, intended to be indicative of the range of manufactured products included in that class, some latitude should be allowed in attributing a meaning to the [primary activities listed]. (p. 302)

*Re Kimberley-Clark* illustrates that it is difficult to contrive a classification outcome that supplants the ordinary meaning of manufacture.

The codification takes the form of a 'positive' list of what is deemed to be manufacturing or other activity, as appropriate. This positive list approach differs from the 'negative' list approach adopted in Customs guidance documents. The disadvantage of this is that the list may not readily adapt or be updated to reflect changes in technology and commercial practice. Nevertheless, the ANZSIC also codifies activities deemed to be non-manufacturing, similar to the Customs 'negative' list. Typically, those excluded activities would be treated as wholesale trade, retail trade or repair activities in the ANZSIC.

## **Annex C.1** Manufacturing processes
Judicial guidance

| *Case* | *Process Undertaken* | *Was it a process of manufacture?* |
|---|---|---|
| *Irving v Munro & Sons Ltd*<br>(1931) 46 CLR 279<br>HIGH COURT | Assembly of motor cycle from imported materials which contained all materials needed, but for tyres and tubes. Assembly completed with the aid of spanner only. | **No**: no activity which amounted to 'manufacture'. |
| *Adams v Rau*<br>(1931) 46 CLR 572<br>HIGH COURT | Shorthand writers: producing shorthand notes of verbal testimony etc in courts and other proceedings. | **No**: notes brought into existence not for sale as commodity, but for supply of service. |
| *Re Searls Ltd*<br>(1932) 33 SR (NSW) 7<br>NSW SUPREME COURT | Making wreaths, bouquets and the like from combining component flowers. | **Yes**: 'new saleable entity is brought into existence'. |
| *FCT v Rochester*<br>(1934) 50 CLR 225<br>HIGH COURT | Cooking of fish | **No**: cooking was not manufacture in the ordinary sense of the word. |
| *FCT v Riley*<br>(1935) 53 CLR 69<br>HIGH COURT | Taking photographs of clients, production of photographs and supplying them to clients | **Yes**: produced an article 'which will be bought'. |
| *FCT v Jack Zinader Pty Ltd*<br>(1949) 78 CLR 336<br>HIGH COURT | Removal of used fur, replacement with new fur and remodelling of the remainder of the garment to reflect modern styling. | **Yes**: 'He has made a different article'. |
| *M P Metals v FCT*<br>(1968) 117 CLR 631<br>HIGH COURT | Collecting of scrap metal, cutting and compressing it into appropriate sizes and sells bales of scrap metal to customers | **No**: process is one of 'bringing goods into a form for sale'. |
| *Dawson v Deputy Commissioner of Taxation*<br>(1984) 56 ALR 367<br>SA SUPREME COURT | Process of providing knowledge, skill, experience and organising services as well as the labour used to convert materials (use of fibreglass and moulds) to produce a yacht hull and deck. | **Yes**: produced an article 'commercially distinct' from the materials. |
| *FCT v Jax Tyres*<br>(1984) 58 ALR 138<br>FEDERAL COURT | Retreading of tyres | **No**: no 'different thing' emerged after retreading process. |
| *Wellington City Council v Attorney-General*<br>(1990) 2 NZLR 281<br>NZ COURT OF APPEAL | Dismantling, repair and replacement of many parts and some modification of road sweep. | **No**: 'essential nature' of road sweep not changed. |
| *WEA Record Pty Ltd v FCT*<br>(1990) 96 ALR 365<br>FEDERAL COURT | Duplication of master video tapes onto blank video cassettes. | **Yes**: brought into existence a 'different commodity'. |

(Continued next page)

Annex C.1 (continued)

| | | |
|---|---|---|
| *Commonwealth v Genex*<br>(1992) 110 ALR 154<br>HIGH COURT | Use of a 'mini-lab' in retail stores to develop photographic film. | **No**: process 'does not amount to the bringing into existence of new goods'. |
| *Re Regals Holdings and CEO of Customs*<br>(1997) 46 ALD 373<br>AAT | Substantial work done to boat – engines, the bridge upper deck, main deck, wheel house, gallery aft deck, staterooms and crew accommodation. | **No**: changes not sufficient to indicate manufacture. No change in the 'nature' of the boat. |
| *Commissioner of Taxation v Softex Industries Pty Ltd*<br>(2001) 191 ALR 724<br>FEDERAL COURT | Collecting, sorting, shredding used paper and compressing it into bales ready to be used by other firms. | **No**: merely making used paper more saleable. |

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